SUPREME COURT, U. S.

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IN THE

Supreme Court of the United States

October Term, 1969

NO. 1130

CAPITAL SOUTHWEST CORPORATION, ET AL,
Appellants

v.

ROBERT S. CALVERT, COMPTROLLER OF PUBLIC ACCOUNTS OF THE STATE OF TEXAS, ET AL,
Appellees

ON APPEAL FROM THE COURT OF CIVIL APPEALS FOR THE THIRD SUPREME JUDICIAL DISTRICT OF TEXAS

JURISDICTIONAL STATEMENT

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JURISDICTIONAL STATEMENT

Appellants[1] appeal from the judgment of the Court

[1] Each of the Appellants herein — Capital Southwest Corporation, Electro-Science Investors, Inc. and Texas Capital Corporation — originally filed individual suits in the Texas state courts against the Appellees to recover Texas state franchise taxes paid by Appellants under protest. The individual suits were tried jointly and then, before the judgment was entered in the trial court, the cases were consolidated both for convenience and because a common ultimate issue was involved. Throughout the state appellate process these cases have proceeded in the consolidated manner. Appellees are those specified by Article 1.05, Title 122A, Taxation — General, and Article 7057b, Texas Civil Statutes, to be defendants in suits by taxpayers to recover Texas state franchise taxes paid under protest, to-wit: Robert S. Calvert, Comptroller of Public Accounts of the State of Texas (the public official charged with the duty of collecting the franchise tax), Mr. Jesse James (State Treasurer of the State of Texas), and the Honorable Crawford C. Martin (the Attorney General of the State of Texas).

of Civil Appeals for the Third Supreme Judicial District of Texas, entered on April 30, 1969, reversing the judgment of the trial court and rendering a decision that Appellants herein take nothing by their suits. Appellants' state court remedies were not exhausted until November 5, 1969, when Appellants' Motion for Rehearing was overruled by the Supreme Court of the State of Texas, thereby refusing to reexamine its earlier refusal to grant the Appellants' Application for Writ of Error. By this Statement the Appellants will show that the Supreme Court of the United States has jurisdiction of the appeal and that a substantial question is presented.

OPINION BELOW

The Opinion of the Court of Civil Appeals for the Third Supreme Judicial District of Texas at Austin, printed in Appendix A hereto, infra, Page 41, is reported in 441 S.W. 2d 247. The Order of Consolidation and Judgment of the Trial Court, the District Court of Travis County, Texas, 126th Judicial District, printed in Appendix B hereto, infra, Page 95, are unreported. The Judgment of the Court of Civil Appeals for the Third Supreme Judicial District of Texas, is printed in Appendix B hereto, infra, Page 105, is unreported. The Order of the Court of Civil Appeals denying Appellants' Motion for Rehearing, printed in Appendix B hereto, infra, Page 107, is unreported. The Order of the Supreme Court of Texas refusing Appel-

lants' Application for Writ of Error with the notation "no reversible error", printed in Appendix B hereto, infra, Page 109, is unreported. The Order of the Supreme Court of Texas overruling Appellants' Motion for Rehearing of their Application for Writ of Error, printed in Appendix B hereto, infra, Page 111, is unreported.

JURISDICTION

These consolidated suits were each brought under and pursuant to the terms, provisions and requirements of Article 1.05, Title 122A, Taxation-General, and Article 7057b, Texas Civil Statutes, to recover the franchise taxes each Appellant has been required by duress to pay under written protest to the State of Texas pursuant to Article 12.01, Title 122A, Taxation-General, Texas Civil Statutes, together with interest thereon as further provided by said Article 1.05. The basis for each Appellants' protest to the effect that the demand for and the collection of said franchise taxes was unlawful, unauthorized, invalid and void was that each Appellant was a "mutual investment company" within the meaning of Article 12.03, Title 122A, Taxation-General, Texas Civil Statutes, and pursuant thereto was exempt from the state franchise tax imposed by said Article 12.01. One of the issues raised by the Appellants in the trial court and preserved throughout the exhaustion of the state appel-

late process was a challenge under the due process and equal protection clauses of the Constitution of the United States to the validity of said Article 12.03 should the state courts construe the above-mentioned exemption for a "mutual investment company" as being limited exclusively to "open-end" investment companies, thus excluding from the exemption "closed-end" investment companies such as the Appellants.

The Judgment of the Court of Civil Appeals reversing the decision of the trial court and rendering a decision that the Appellants take nothing by their suits was entered on April 30, 1969. Appellants filed a timely Motion for Rehearing in the Court of Civil Appeals, which motion was overruled on May 28, 1969. Appellants then sought review of the Judgment of the Court of Civil Appeals by filing a timely application for Writ of Error to the Supreme Court of Texas. On October 1, 1969, the Texas Supreme Court entered an Order refusing Appellants' Application for Writ of Error. Appellants filed a timely Motion for Rehearing in the Texas Supreme Court seeking a reexamination of that Court's refusal to grant Appellants' Application for Writ of Error. The Order of the Texas Supreme Court overruling Appellants' Motion for Rehearing of their Application for Writ of Error was entered on November 5, 1969.

On January 14, 1970, simultaneous Notices of Appeal were filed by Appellants in both the Texas Court

of Civil Appeals for the Third Supreme District and in the Texas Supreme Court. The jurisdiction of the Supreme Court to review this decision on appeal is conferred by Title 28, United States Code, Section 1257(2). The following decisions sustain the jurisdiction of the Supreme Court to review on appeal the judgment of the Texas Court of Civil Appeals after it has been in effect affirmed by the Texas Supreme Court by its refusal to grant the Appellants' Application for Writ of Error: *Interstate Circuit, Inc. v. Dallas* and *United Artists Corp. v. Dallas*, 390 U.S. 676, 88a S. Ct. 1298, 20 L. Ed. 2d 225; *Michigan-Wisconsin Pipe Line Co. v. Calvert et al* and *Panhandle Eastern Pipe Line Co. v. Calvert et al*, 347 U.S. 157, 74 S. Ct. 396, 98 L. Ed. 583; *American Railway Express Co. v. Levee*, 263 U.S. 19, 44 S. Ct. 11, 68 L. Ed. 140; and *Lone Star Gas Co. v. State of Texas*, 304 U.S. 224, 58 S. Ct. 883, 82 L. Ed. 1304. The following cases sustain the jurisdiction of the Supreme Court to review on appeal a Federal constitutional objection based on the outcome of statutory construction issues presented in the state courts: *Kingsley International Pictures Corp. v. Regents of the University of the State of New York*, 360 U.S. 684, 79 S. Ct. 1362, 3 L. Ed. 2d 1512; *United States v. Burnison*, 339 U.S. 87, 70 S. Ct. 503, 94 L. Ed. 675; *Aero Mayflower Transit Co. v. Board of R.R. Commissioners*, 332 U.S. 495, 68 S. Ct. 167, 92 L. Ed. 99; and *Guaranty Trust Co. v. Blodgett*, 287 U.S. 509, 53 S. Ct. 244, 77 L. Ed. 463.

The text of said Article 12.03 (formerly Article 7094) along with the emergency clause accompanying the passage of the 1951 amendment declaring the exemption for a "mutual investment company" as it appeared in 1951 is as follows:

"MUTUAL INVESTMENT COMPANIES — FRANCHISE TAX
"CHAPTER 143
"S. B. NO. 6

"An Act amending Article 7094, Revised Civil Statutes of Texas of 1925, as amended; and declaring an emergency.

"BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF TEXAS:

"Section 1. That Article 7094, Revised Civil Statutes of Texas of 1925, as amended, be and the same is hereby amended so as to read hereafter as follows:

" 'Article 7094

" 'The franchise tax imposed by this Chapter shall not apply to any insurance company, surety, guaranty or fidelity company, or any transportation company, or to any corporation organized as a terminal corporation not organized for profit and having no income from the business done by it, or to any sleeping, palace car and dining car company now required to pay an annual tax measured by their gross receipts, or to corporations having

no capital stock and organized for the exclusive purpose of promoting the public interest of any city or town, or to corporations organized for the purpose of religious worship or for providing places of burial not for private profit, or to corporations organized for the purpose of holding agricultural fairs and encouraging agricultural pursuits, or for strictly educational purposes, or for purely public charity, or to State-chartered building and loan associations, or to any mutual investment company registered under the Federal Investment Company Act of 1940, as from time to time amended, which holds stocks, bonds, or other securities of other companies solely for mutual investment purposes.'

Section 2. The fact that the sole source of income of such mutual investment companies is from receipt of dividends or interest on stocks, bonds, or other securities of other corporations (held solely for investment purposes by such mutual investment companies), and the fact that such other corporations already are subject to and pay a franchise tax; that the subjection of such mutual investment companies to a franchise tax in effect taxes the same source twice, as is recognized by the Federal Government in exempting from Federal Income Taxes the income of such mutual investment companies which is distributed to their shareholders; the fact that mutual investment companies doing business in many other States are granted exemptions from franchise taxes whereas mutual investment companies doing busi-

ness in the State of Texas are not exempt from franchise taxes, thereby placing the latter companies at an unfair disadvantage with respect to selling its shares to Texas investors; that such mutual investment companies should be encouraged to do business in Texas; that the calendars of both Houses are likely to become crowded; and the further fact that the changes proposed herein need to become effective at the earliest possible time, create an emergency and an imperative public necessity, authorizing the Constitutional Rule requiring bills to be read on three several days in each House be suspended; and said Rule is hereby suspended, and this Act shall take effect and be in force from and after its passage, and it is so enacted.

"Passed the Senate, March 26, 1951, by a viva voce vote; passed the House, April 26, 1951; Yeas 49, Nays 38.

"Approved May 10, 1951.

"Effective 90 days after June 8, 1951, date of adjournment." (Emphasis added to point out the pertinent portions of the exemption statute.)

Since 1951, several non-material amendments have been made to the foregoing statute and in 1959 it was renumbered as Article 12.03. The current version of Article 12.03 may be found in Volume 20A, Vernon's Annotated Civil Statutes of Texas, Taxation-General at page 280.

QUESTION PRESENTED

Whether that portion of Article 12.03 exempting "mutual investment companies" from the Texas state franchise tax (which exemption has now been construed to mean that the exemption is only available to "open-end" investment companies to the complete exclusion of all "closed-end" investment companies including Appellants) is an unreasonable and/or arbitrary classification having no relation to the declared purpose of the exemption so as to render the statutory exemption in question unconstitutional in violation of Appellants' due process and/or equal protection guarantees under the Fourteenth Amendment of the Constitution of the United States?

STATUTES AND CONSTITUTIONAL PROVISION INVOLVED

Articles 1.05, 12.01 and 12.03, Title 122A, Taxation-General, Texas Civil Statutes; Article 7057b, Texas Civil Statutes; and United States Constitution, XIV Amendment, Section 1.

STATEMENT OF THE CASE

In 1951 the Texas Legislature amended Article 12.03, Title 122A, Taxation-General, Texas Civil Statutes, to include an exemption from the state franchise tax for "mutual investment companies". The pertinent portion of that statute reads:

> "The franchise tax imposed by this Chapter shall not apply to . . . any mutual investment company registered under the Federal Investment Company Act of 1940, as from time to time amended, which holds stocks, bonds, or other securities of other companies solely for mutual investment purposes."

The emergency clause[2] accompanying the foregoing amendment expressly declared the legislative intent and purpose in enacting the exemption to be the elimination of a double taxation effect on mutual investment companies doing business in Texas in order to encourage these mutual investment companies to come into Texas. Since the taxable capital of these mutual investment companies on which the franchise tax was being imposed was made up of stocks, bonds, and securities of portfolio companies who themselves often were subject to franchise taxes or taxes in the nature of franchise taxes in the states where they did business, the legislative concern was that unless Texas afforded an exemption from franchise taxes similar

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[2] The full text of this emergency clause is set forth above under the heading JURISDICTION.

[3] The phenomenon of double taxation of the same source can best be seen from the viewpoint of a shareholder of one of these mutual investment companies. The taxable capital of a mutual investment company consists almost entirely of securities of portfolio companies. If the portfolio companies are themselves subject to a franchise tax with the attendant effect on their stock, and if the taxable capital of a mutual investment company which is made up of these portfolio stocks is also subjected to a franchise tax, this in effect is taxation of the same source twice.

to that afforded by other states, mutual investment companies doing business in Texas would be at a distinct disadvantage in relation to investment companies operating outside the State of Texas insofar as selling its shares to investors.[3] It is a fair summary, therefore, to say that the purpose of the exemption was to free mutual investment companies doing business in Texas from the double taxation effect generated by the state's franchise tax, with the hoped-for consequence that these companies would be encouraged to come into Texas.[4]

At all material times Appellants were closed-end investment companies registered under the Federal Investment Company Act of 1940 and also licensed under the Small Business Investment Company Act of 1958. Acting independently of one another, each of the Appellants at varying times requested from the State Comptroller's Office the franchise tax exemption for mutual investment companies. In response to these requests, all but Appellant Capital Southwest Corporation were initially granted the exemption. Electro-

[4] It is of interest to note that in spite of the avowed legislative purpose to attract mutual investment companies into Texas, under the interpretation given the exemption by the agency charged with the collection of franchise taxes (which has now been adopted by the Texas Supreme Court) to the effect that only "open-end" investment companies are eligible, only five investment companies have been granted an exemption in the period 1951-1968, all of which were "open-end." (S.F. 563-64) It is further interesting to note that of the five exempt investment companies, four are Texas corporations having identical officers and directors.

Science Investors, Inc. was notified of its exempt status by letter dated May 22, 1961 (Electro-Science Investors, Inc. Exhibit 12, S.F. 242-244, Vol. IV), and Texas Capital Corporation received its notification by letter dated June 22, 1961. (Texas Capital Corporation Exhibit 2, S.F. 13, Vol IV)

Subsequently Robert S. Calvert, Comptroller of Public Accounts of the State of Texas, made separate inquiries of the Securities and Exchange Commission concerning each of the Appellants which had been granted the exemption as to whether each of the companies was a "mutual investment company."[5] By letter dated July 20, 1961, the Securities and Exchange Commission responded to the inquiry regarding Texas Capital Corporation by stating that while that corporation was an "investment company" as defined in the Federal Investment Company Act of 1940, the term "mutual investment company" was neither used nor defined in that Act. The reply went on to mention, however, that the investment industry commonly used the term "mutual fund" to describe an investment company that constantly stands ready to redeem its

[5] The logic in looking to the Securities and Exchange Commission, which had no jurisdiction or contact whatsoever with the Texas exemption statute, in order to determine if Appellants were "mutual investment companies" has never been satisfactorily explained. Moreover, in making the inquiries of the Securities and Exchange Commission, the Comptroller completely omitted all reference to the emergency clause wherein the purpose of the exemption is set forth.

shares at current net asset value, such company being denominated as an "open-end" investment company. Further, the reply noted that Texas Capital Corporation was a "closed-end" investment company and concluded by once again emphasizing that the terms "mutual" or "mutual fund" did not appear in the Federal Investment Company Act of 1940. (Texas Capital Corporation Exhibit 4, S.F. 36, Vol. IV)

The Comptroller made an identical inquiry of the Securities and Exchange Commission regarding Electro-Science Investors, Inc. on December 11, 1961. (Electro-Science Investors, Inc. Exhibit 13, S.F. 244, Vol. IV) By letter dated December 21, 1961, the Securities and Exchange Commission made reply similar to that given with regard to Texas Capital Corporation. The Securities and Exchange Commission quite properly declined to interpret the Texas statute over which it had no jurisdiction, but the Commission did explain and offer its views on the applicability of the term "mutual investment company" to a "closed-end" investment company. (Electro-Science Investors, Inc. Exhibit 14, S.F. 244, Vol. IV):

> "A closed-end investment company may also fall within the definition of a 'mutual investment company' since the ownership of a share of stock in such company is an interest in the portfolio holdings of the company in proportion to his stock ownership of the company."

The Comptroller not only ignored the above quoted opinion but he completely misread the Commission's letters. (S.F. 31-34) The Securities and Exchange Commission's letters stated that the investment industry commonly referred to open-end investment companies as "mutual funds", it did not say that there existed a common definition of what a "mutual investment company" is nor did it say that a "mutual investment company" is commonly understood to mean an "open-end" investment company. The foregoing quote illustrates quite the contrary. Nevertheless, a student-auditor on the Comptroller's staff issued a memorandum to the official charged with the determination of this question of the Appellants' exemption wherein the memo writer completely misinterpreted the Commission's letter (Texas Capital Corporation Exhibit 6, S.F. 36, Vol. IV):

> "I feel that the information supplied by the Securities and Exchange Commission on July 20, 1961, clearly indicates that the subject corporation is subject to franchise tax and is not covered by that provision of Article 12.03 that deals with Mutual Investment Companies. I would say that there are two qualifications that a corporation must meet under this exemption. First, it must be a mutual investment company. Secondly, it must be registered under the Federal Investment Company Act of 1940. Since the generally accepted term of mutual investment company is an open-end investment company, I feel that we can successfully defend the

position that the Legislature intended mutual investment company to have its generally accepted meaning." (Emphasis added to highlight the misinterpretation.)

Based solely on these letters received from the Securities and Exchange Commission wherein the Commission expressly declined the attempt to define an exemption created by a statute over which it had no jurisdiction; which letters were subsequently misconstrued, the Comptroller reversed his former position and informed Appellants Texas Capital Corporation and Electro-Science Investors, Inc. that they were being denied the exemption because they were not "open-end" companies. These precedents likewise formed the basis for the denial of exemption to Capital Southwest Corporation when it applied for the exemption somewhat later.

It is undisputed that at all material times each of the Appellants was an investment company registered under the Federal Investment Company Act of 1940 which held stocks, bonds and other securities of other companies solely for mutual investment purposes. This was the very nature and essence of the Appellants' business and it tracked the language of the exemption statute exactly. Believing, therefore, that they were within the scope of the exemption Appellants, individually, followed the only course open to them. Under duress from the Comptroller's Office, Appellants paid their annual

franchise tax under protest and filed separate suits in the manner specified by Article 1.05, Title 122A, Taxation-General, and Article 7057b, Texas Civil Statutes, claiming they were exempt as mutual investment companies. Each year while the cases were awaiting trial, the Appellants paid their respective annual franchise tax under protest and amended their petitions accordingly. At the time of trial in May 1968, the Appellants had paid the following amounts as franchise taxes under protest: Capital Southwest Corporation $251,448.94; Electro-Science Investors, Inc. $97,820.86; and Texas Capital Corporation $146,704.05. Appellees concede that Appellants complied with all the procedural requirements for bringing suit to recover franchise taxes paid under protest. (Appellants', who are here the Appellees, Brief in the Texas Court of Civil Appeals page 2).

Since a common question was presented by the three separate suits filed by the Appellants, and since much of the evidence to be presented at the trial applied equally in behalf of the three Appellants, the state District Court in which the suits were filed entered a pretrial order ordering the Appellants' cases to be tried jointly and concurrently. (Pre-Trial Order, Tr. 40)

At the commencement of the non-jury trial before the 126th Judicial District Court on May 27, 1968, the Court reiterated the groundrules under which the cases were being tried. (S.F. 3-5, and 223-224) For purposes

of this appeal it is important only to note the ground-rule that if the trial court decided the Appellants were entitled to the exemption, the cases would be consolidated prior to a judgment being entered so that they could be appealed under one record.

During the course of the trial the evidence put on by the Appellants not only bore on the issue of whether they were entitled to the exemption, but it also bore on the question of the validity of the exemption statute under the state and Federal Constitutional challenges of due process and/or equal protection should the trial court rule that the exemption for mutual investment companies did not apply to the Appellants. (See, e.g., S.F. 554-556)

An "investment company" is defined in 15 United States Code §80a-3, the statute commonly known as the Federal Investment Company Act of 1940 which is referred to in the exemption statute in question. The definition encompasses a company that is engaged primarily in the business of investing and/or trading in the securities of other companies, referred to as portfolio companies. It being undisputed that Appellants each met the definition of an investment company, attention was focused on the word "mutual" as it appeared in the term "mutual investment company". During the course of the trial it was clearly established that the sole reason the Comptroller denied Appellants the exemption was that they were not "open-end" in-

vestment companies. (S.F. 247) An "open-end" investment company is one that at all times stands ready to sell or redeem any or all of its shares at approximately their net asset value. In contrast, a "closed-end" investment company such as the Appellants does not necessarily stand ready at all times to redeem its shares, the value of which shares do not bear any relationship to net asset value of its portfolio securities but is instead determined in the market place.

Mr. W. Luther Estes, Director of the Franchise Tax Division of the Comptroller's Office and the official charged with the duty of determining franchise tax exemptions, testified that the determination of whether a corporation qualifies for an exemption is made without reference or regard to its charter, bylaws, or the manner in which it conducts its business. (S.F. 555, 564, 567-568) The sole test applied by his office was whether the investment company was "open-end". (S.F. 252) He further testified that if the Appellants merely amended their corporate charters so as to become "open-end" companies, and all other facts remained the same, the Appellants would be assigned an exempt status as a "mutual investment company". (S.F. 21) Reduced to the simplest terms, therefore, the Appellees' position throughout was that the word "mutual" in the exemption granted "mutual investment companies" is an exclusive synonym interchangeable only with the word "open-end".

At the conclusion of the trial, which lasted three days and consisted almost entirely of evidence introduced by the Appellants, the trial judge announced that in view of the evidence taken, and in light of the legislative purpose of the exemption, he was going to find that the Appellants were "mutual investment companies" entitled to the exemption. Pursuant to the understanding reached before trial, the Appellants' cases were consolidated prior to the entry of the judgment. This having been accomplished, a judgment was entered on July 10, 1968, declaring the Appellants to be exempt as mutual investment companies and directing the State of Texas to refund the franchise taxes paid by Appellants under protest together with interest thereon. Since the trial court ruled the Appellants were exempt as mutual investment companies, no express ruling was made on the issue dealing with the validity of the statutory exemption under the due process and/or equal protection clauses of the state and Federal Constitutions.

From the judgment of the trial court, the Appellees herein duly perfected their appeal to the Court of Civil Appeals, contending as they had all along that the exemption for "mutual investment companies" was limited to only "open-end" investment companies. Included among the Counterpoints raised by the Appellants herein in their brief in the intermediate court was the following challenge fully supported by authorities as required under Rule 420 of the Texas Rules of Civil Procedure:

"IV

"The trial court correctly entered judgment for Appellees because the contrary construction of the exemption statute urged by Appellants would unreasonably discriminate against the Appellees, thereby rendering the statute unconstitutional, as being violative of the due process and equal protection clauses of the Texas and United States Constitutions (in reply to Appellants' Points I, II, III, IV, and V)."

On April 30, 1969, the Court of Civil Appeals reversed the trial court and rendered a judgment that the Appellants herein take nothing by their suits. In so ruling, the intermediate court upheld the Appellee's contention that the exemption was only available for "open-end" investment companies. The Court of Civil Appeals' opinion reported in 441 S.W. 2d 247 further contained the following decision on the above quoted Counterpoint at page 269-270:

"[16] Appellees have a counterpoint to the effect that if we hold as we have held then Art. 12.03 would be unconstitutional because it would unreasonably discriminate against them and would violate the due process and equal protection clauses of the Constitutions of the United States and Texas.

We overrule this point.

The discrimination which is said to exist is in not exempting "closed-end" investment companies

as appellees are as well as "open-end" investment companies.

[17] The Legislature has broad discretion in classifying subjects for tax purposes. Its only restriction is that the classification not be unreasonable or arbitrary. Considering the material differences between these two types of investment companies, as pointed out in this opinion, we do not believe the Legislature acted arbitrarily or unreasonably in exempting from payment of franchise taxes only "open-end" or mutual investment companies.

The judgment of the trial court is reversed and judgment is here rendered that appellees take nothing by their suits.

Reversed and rendered."

In their Motion for Rehearing, filed on May 15, 1969 in the intermediate court, the Appellants included as an Assignment of Error the foregoing point that the exemption statute was in violation of the due process and/or equal protection clauses of the state and Federal Constitutions if construed so as to apply only to "open-end" investment companies because, in light of the legislative purpose, such a classification between "open-end" and "closed-end" investment companies was unreasonable and arbitrary. (Appellees, here Appellants, Motion for Rehearing pages 8 and 28) It was there argued by Appellants that there was no reasonable basis for any classification between open-end and

closed-end investment companies which is even remotely related to the purpose of the exemption statute. The Court of Civil Appeals overruled this Motion for Rehearing on May 28, 1969.

On June 30, 1969, Appellants filed their Application for Writ of Error to the Supreme Court of Texas. Included in the Appellants' Points of Error therein was the following Point directed at that portion of the Court of Civil Appeals' opinion quoted above wherein the intermediate court held that the exemption statute, as it had construed it, did not violate the due process and/or equal protection clauses of both the state and Federal Constitutions:

"Point VI

> "The Court of Civil Appeals erred in holding that the classification between open-end and closed-end investment companies under Respondents' and the Court of Civil Appeals' construction of the phrase "mutual investment company" is not arbitrary and, therefore, not unconstitutional (germane to Motion for Rehearing, Assignment VI)."

Under this Point, Appellants continued to argue that there must be a reasonable basis for classification which is germane to the purpose of the exemption statute, and that none of the distinction between "open-end" and "closed-end" investment companies are relevant or material to the purpose of the legislation. (Petitioners, here Appellants, Application for Writ of Error pages

27 and 60 et seq.) In spite of the brief accompanying this Point of Error demonstrating at great length that the reasons given by the legislature in enacting the exemption applied equally to both "open-end" and "closed-end" investment companies, the Texas Supreme Court on October 1, 1969, entered an order refusing the Appellants' Application, with the accompanying notation that the opinion of the Court of Civil Appeals contained "no reversible error." [6]

On October 16, 1969, Appellants filed their Motion for Rehearing in the Texas Supreme Court wherein Appellants continued to argue, among other points, the federal question previously raised. However, on November 5, 1969, the Texas Supreme Court overruled Appellants' Motion, thus making final the Court of Civil Appeals' judgment in all respects, including its decision overruling Appellants' challenge that the court's construction violated the due process and/or equal protection guarantees of the Texas and United States Constitutions.

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[6] The Texas Supreme Court had authority under Article 1728, Texas Civil Statutes, to exercise its appellate jurisdiction because the decision of the Court of Civil Appeals involved "the construction or validity of statutes necessary to a determination of the case." Rule 483, Texas Rules of Civil Procedure, contemplating the Texas Supreme Court's discretionary exercise of its appellate jurisdiction, provides in part that "In all cases where the Supreme Court is not satisfied that the opinion of the Court of Civil Appeals in all respects has correctly declared the law, but is of the opinion that the application presents no error which requires reversal, the Court will deny the application, with the notation 'Refused. No Reversible Error'."

GROUNDS AND REASONS THIS QUESTION IS SUBSTANTIAL

In construing the Texas statute creating the exemption from state franchise taxes for "mutual investment companies", the Court of Civil Appeals found that the Texas Legislature in enacting the pertinent portions of Article 12.03 exempted only "open-end" investment companies, to the complete exclusion of "closed-end" investment companies such as Appellants. Moreover, by refusing the Appellants' Application for Writ of Error with the notation "no reversible error", the Texas Supreme Court thereby made final the intermediate state appellate court's judgment and opinion overruling Appellant's continuous challenge that if the exemption was only for "open-end" investment companies, the exemption statute established an unreasonable and/or arbitrary classification or distinction having no relationship to the purpose of the statutory exemption, thereby rendering the statute in violation of the due process and/or equal protection clauses of the Fourteenth Amendment of the United States Constitution. Having drawn in question the validity of a Texas state statute as construed on the ground of its being repugnant to the Constitution of the United States, and the decision of the highest court of Texas being in favor of the statute's validity, Appellants by this appeal seek a re-examination by this Honorable Court of the federal question presented.

While a state legislature may make classifications, such classifications must be reasonable and not arbitrary, and there must be a reasonable basis for the classification which is germane to the purpose of the statute. The foregoing was expressed in the landmark case in this area, *Louisville Gas & Elec. Co. v. Coleman*, 277 U.S. 32, 48 S. Ct. 423, 72 L. Ed. 770 wherein the Court stated (48 S. Ct. 425):

> "... the power of the state to classify for purposes of taxation is of wide range and flexibility provided always that the classification 'must be reasonable, not arbitrary, and must rest upon some ground of difference having a fair and substantial relation to the object of the legislation, so that all persons similarly circumstanced shall be treated alike'. . . . That is to say, *mere* difference is not enough; the attempted classification 'must always rest upon some difference which bears a reasonable and just relation to the act in respect to which the classification is proposed, and can never be made arbitrarily and without any such basis.'"

Similarly, in *Hartford Steam Boiler Inspection and Insurance Company v. Harrison*, 301 U.S. 459, 57 S. Ct. 838, 81 L. Ed. 1228, the Court quoted the above general rules and then stated (57 S. Ct. 840):

> "Despite the broad range of the State's discretion, it has a limit which must be maintained if the constitutional safeguard is not to be overthrown. Discriminations are not to be supported by mere fanciful conjecture. Borden's Company v. Baldwin, 293 U. S. 194, 209, 55 S. Ct. 187, 191, 79 L. Ed.

281. They cannot stand as reasonable if they offend the plain standards of common sense."

The Court there had before it a Georgia statute which permitted mutual insurance companies to act through salaried resident employees but excluded stock companies from the same privilege. In holding the classification arbitrary, unreasonable, and a denial of equal protection of the law, the Court said (57 S. Ct. 840):

> "It is idle to elaborate the differences between mutual and stock companies. These are manifest and admitted. But the statutory discrimination has no reasonable relation to these differences. We can discover no reasonable basis for permitting mutual insurance companies to act through salaried resident employees and exclude stock companies from the same privilege." (Emphasis added.)

The above rules were discussed and followed in *Morey v. Doud*, 354 U. S. 457, 77 S. Ct. 1344, 1 L. Ed. 2d 1485, wherein the Court noted that a "statutory discrimination must be based on differences which are reasonably related to the purposes of the Act in which it is found."

It will be recalled that the legislature, in enacting the exemption, was concerned that Texas had fallen behind other states in the treatment of mutual investment companies under its franchise tax laws, with the resulting fear that unless Texas fell into step with the other states that had already eliminated the double taxation

phenomenon on mutual investment companies, these companies would not be eager to do business in Texas. With the purpose of the exemption thus clearly in mind, Appellants will demonstrate that a statute exempting only "open-end" investment companies, to the exclusion of all "closed-end" investment companies, creates an unreasonable classification having no nexus to the legislative purpose and, therefore, violative of the principle enunciated in the landmark *Louisville Gas* case cited above.

Disecting the emergency clause which accompanied the passage of the exemption for "mutual investment companies", it becomes readily apparent that the Appellants as "closed-end" investment companies meet the four considerations listed therein in the same manner and to the same extent as "open-end" investment companies which are afforded exemption.

(1) The first of the four considerations appearing in the emergency clause is:

> "The fact that the sole source of income of such mutual investment companies is from receipt of dividends or interest on stocks, bonds, or other securities of other corporations (held solely for investment purposes by such mutual investment companies), and the fact that such other corporations already are subject to and pay a franchise tax;"

Appellants at the trial put on expert testimony that they, as "closed-end" investment companies, to the same

extent as "open-end" investment companies, derived their income from the receipt of dividends or interest on stocks, bonds, or other securities of other corporations held solely for investment purposes. (S. F. 493-502) In the only reported opinion of this case, the Court of Civil Appeals made an attempt to distinguish Appellants under the "sole source of income" portion of the emergency clause by citing isolated instances where Appellants derived income from sources other than dividends or interest. (See, e.g., 441 S.W.2d at 264 and 267) The intermediate court even went to the extreme of stating that the foregoing quoted portion of the emergency clause is a "requirement" of being a "mutual investment company" and is to be strictly and literally construed as such. (441 S.W.2d 250) Not only does the elevation of a portion of the emergency clause to the status of being a "requirement" of the exemption statute offend the well-established rule of statutory construction that an emergency clause is consulted only to determine legislative intent, but the Court of Civil Appeals in so doing failed to establish the distinction between "open-end" and "closed-end" investment companies that it was seeking. If it were a "requirement" that in order to be a "mutual investment company" the company's sole source of income must be from dividends or interest on stock, bonds, or other securities of other corporations, then not even an "open-end" investment company would qualify for the exemption. All investment companies, whether

open-end or closed-end, necessarily have as an objective the realization of gains from the sale of its portfolio securities at an appreciated price. Such gains, while clearly income to the investment company, are just as clearly not "dividends or interest" as the intermediate court's opinion seeks to require. It is a matter of common knowledge that the five open-end investment companies which have been granted an exemption derive their greatest amount of income from realized appreciation of their portfolios.

(2) The second consideration mentioned by the legislature in the emergency clause is:

> "... that the subjection of such mutual investment companies to a franchise tax in effect taxes the same source twice, as is recognized by the Federal Government in exempting from Federal Income Taxes the income of such mutual investment companies which is distributed to their shareholders;" (Emphasis added.)

The phenomenon of how the same source is taxed twice where a franchise tax is imposed on a mutual investment company has been described above. At the trial, Appellants introduced into evidence various stipulations they had entered into with the Appellees demonstrating that most of their portfolio companies were themselves subject to a franchise tax in the states where they were doing business. Therefore, it is clear that the double taxation objection which the legislature was concerned with is equally present in both open-end

and closed-end investment companies. (S. F. 103-104; 107-109)

That the double taxation objection is equally applicable to both open-end and closed-end investment companies is also supported by the underscored portions of the foregoing quote which make it clear that the legislature, in adopting the phrase "mutual investment company", had in mind an investment company similar to those which received the favored treatment by the Internal Revenue Service. The reference could only have contemplated those types of investment companies known as "regulated investment companies" controlled by §361 of the Internal Revenue Code of 1939 (now §851 of the Internal Revenue Code of 1954) which exempted "regulated investment companies" from the tax on income which was distributed to shareholders because to do otherwise would be to tax the same source twice — once in the hands of the corporation and again in the hands of the shareholders. "Regulated investment companies" is defined in §361 (now §851) to include:

> "any domestic corporation . . . which at all times during the taxable year is registered under the Investment Company Act of 1940 . . . as a management company."

By referring then, as one must, to the Federal Investment Company Act of 1940, Section 80a-5 expressly defines an investment company of the management type to include both open-end and closed-end investment companies.

The point to be made is this: since the legislature referred to a federal income tax law to illustrate how the federal government relieved the double taxation phenomenon on "such mutual investment companies", and since the relief afforded under the federal statute referred to extends to both open-end and closed-end investment companies, then the relief afforded under the Texas franchise tax exemption should likewise have extended to both types of investment companies.

(3) The third consideration found in the emergency clause is:

> "... the fact that mutual investment companies doing business in many other States are granted exemptions from franchise taxes whereas mutual investment companies doing business in the State of Texas are not exempt from franchise taxes, thereby placing the latter companies at an unfair disadvantage with respect to selling its shares to Texas investors;"

Both the Appellants and Appellees agree that in 1951 at the time of the enactment of the exemption in question, there was no common definition of the term "mutual investment company." (441 S.W.2d at 252) Although Appellants have maintained throughout that the words of the exemption itself define a "mutual investment company" to be one (1) registered under the Federal Investment Company Act of 1940, (2) which holds stocks, bonds, or other securities of other

corporations solely for mutual investment purposes, the foregoing quotation from the emergency clause supports the proposition that to merely exempt "open-end" investment company finds no reasonable basis in the purpose of the exemption.

Obviously, the legislature in making the above statement, had reference to some entity that was receiving favored franchise tax treatment in other states — but what entity? Appellees in their brief before the Court of Civil Appeals make the following admission which is quoted in the court's opinion (441 S.W.2d 262):

> "We have examined the laws of all other 49 states and we find no state which exempts or even mentions mutual investment companies in the context of their being exempt from or receiving favorable treatment under its franchise tax or other similar corporate tax laws. We do find several states which extend favorable tax treatment to regulate(d) investment companies as defined under the Federal Income Tax laws . . . .
>
> Our investigation of the laws of the other 49 states in this respect reveals that eight other states do extend favored treatment under their franchise tax, or similar corporate taxing statutes to regulate(d) investment companies, as defined under the present Federal Income Tax laws."

While other states may use different terminology in exempting investment companies from that state's franchise tax, as contrasted to Texas' use of the term

"mutual investment company", those states that do extend such favored treatment do so to both open-end and closed-end investment companies. The definition of "regulated investment company" referred to in the preceding quote includes both open-end and closed-end varieties.

The conclusion, therefore, is inescapable. The legislature in enacting the exemption for "mutual investment companies", had as its purpose placing Texas on a competitive par with other states which did exempt such companies from their franchise tax. To limit and classify the exemption to only "open-end" investment companies while other states exempt both open-end and closed-end investment companies still leaves Texas with a competitive disadvantage which the legislature was of a mind to eliminate. More important for purposes of this appeal, the foregoing discussion under this third consideration affords one of the clearest examples of the classification having no reasonable basis in the purpose of the statute.

(4) The fourth, and final, consideration found in the emergency clause is not so much a point of contention as it is of observation:

> "... that such mutual investment companies should be encouraged to do business in Texas."

In view of what has been said above, it seems obvious that the State of Texas had a legitimate interest in encouraging both open-end and closed-end investment

companies by means of the exemption. Only by extending favored treatment to both varieties of investment companies could it be expected that the encouragement sought to be generated would be sufficiently broad to place Texas on a par with states with which it was seeking to compete.

Appellants are in the very awkward position in this High Court of having to accept the construction placed upon the exemption statute in question, and then argue the federal question presented under this premise. In truth and in fact, Appellants still insist that the Texas Legislature did exempt them by the term "mutual investment company" since Appellants meet all the requirements and purposes of the statute in an equal manner with "open-end" investment companies. It is submitted that the reason both Texas appellate courts went astray on the statutory construction question was simply that instead of focusing attention on what the legislature meant by the term "mutual investment company", which would have been the proper approach, the state appellate courts started with the assumption that "open-end" investment companies were exempt and then proceeded to list all the differences between open-end and closed-end companies.[7] Since differences do exist, the state appellate courts concluded that Appellants were different from companies that were

[7] This misdirection of emphasis is illustrated by referring to the opinion of the Court of Civil Appeals wherein Appellants are denominated Appellees (441 S.W.2d at 259):

> "[12] Appellees also contend that the term 'mutual investment company' in the context of the entire statute includes both open-end and closed-end investment companies. Also, that to adopt appellants' construction of the statute would make the subject, a 'mutual investment company' more restrictive than the modifying phrases. We fail to follow the logic of this argument. If a statute provides that a white house with a chimney and a red picket fence is entitled to certain rights, would brown and green houses having chimneys and red picket fences also be included?"

In the foregoing example advanced by the Court, the singling out of a "white house" as the starting premise demonstrates the Appellants' criticism that the court started their inquiry on the assumption that "open-end" investment companies were exempt. To salvage the Court of Civil Appeals' example and make it relevant to this case, the example they should have used is:

> If a statute provides that a house with a chimney and red picket fence is entitled to certain rights, would this mean only white houses?

This example can be analogized to Article 12.03. The word "house" can be analogized to the phrase "mutual investment company", and the words "chimney and red picket fence" can be analogized to the qualifying words "registered under the Federal Investment Company Act of 1940 . . . which holds stocks, bonds, or other securities of other corporations solely for mutual investment purposes" appearing in Article 12.03. Accepting the rephrasing of the example as demonstrating the correct approach, if one then answers Appellants' rephrased example "yes" as the Texas state appellate courts have now done in holding only "open-end" investment companies are exempt, what you are doing is holding that the word "house" is more limited than the qualifying phrases that follow it. Appellants cannot demonstrate the fallacy more graphically.

exempt and, therefore, as closed-end companies Appellants were not exempt. What they forget is that the differences which do exist have no bearing whatsoever on the purpose of the statute. For example, how can the fact that Appellants do not at all times stand ready to redeem their shares have any relevancy to the purpose of the exemption; and yet this is perhaps the major difference cited by the state appellate courts. It is this oversight or omission to inquire into the relevancy of these differences to the purpose of statute that forms the basis of the federal question presented. If this Court sets this case for plenary consideration, for the first time since leaving the trial court, judicial scrutiny will be focused on the proper inquiry.

Appellants believe that they have shown that the federal questions presented are not frivolous or without merit. Recalling that the Appellants have demonstrated that not only do they meet the express requirements set forth in the exemption statute itself but also that the purposes and reasons behind the exemption equally apply to them as "closed-end" companies can it be said with certainty that the Texas statute exempting only "open-end" investment companies is a classification bearing a reasonable relationship to the legislative purpose? Appellants think not, and submit the federal questions presented are so substantial as to require plenary consideration, with briefs on the merits and oral argument, for their resolution.

Finally, Appellants would show that the significance of this case extends far beyond the Appellants herein. The vehicle for this extended effect is the impact the tax dollars will have on the shareholders of both the closed-end investment companies which have been denied exemption and the open-end companies which have heretofore been exempted. The means whereby this effect will be felt by the shareholders is the same double taxation phenomenon discussed herein.

Most obvious is the effect on the shareholders of the closed-end companies, including Appellants, should the Court determine the exemption statute in its current posture is violative of the United States Constitution. A remand of this case for proceedings not inconsistent with such a decision would surely result in the Appellants' recoupment of the taxes paid under protest and an exemption for closed-end investment companies in the future. Appellants' shareholders alone number in excess of ten thousand and are spread across the country.

Perhaps less obvious is the possible effect on the shareholders of the five exempted open-end investment companies should this Court decide not to hear the case. This will leave the rendition by the Court of Civil Appeals as the only reported opinion construing the term "mutual investment company", which judgment has been in effect affirmed by the Texas Supreme Court. That opinion creates, rather than eliminates, unans-

wered questions and potential chaos that can charitably be described as a "sophistic Miltonian Serbonian bog."

The confusion lies in the fact that the opinion cites six "requirements" that must be met before one is a "mutual investment company" (441 SW 2d at 250-251). The questions are several: Could Appellants secure exemption by becoming open-end investment companies? The court's opinion indicates not, but the testimony of the Comptroller's representative in the trial court would require an affirmative answer. Has the Comptroller's office lost thousands of tax dollars by erroneously exempting the existing open-end investment companies? If the interpretation given the statute by the state appellate courts is correct and allowed to stand, this is certainly the case because the open-end investment companies which have been exempted by the Comptroller's Office since Article 12.03 was passed do not qualify for the exemption under the court's interpretation of the statute imposing the additional "requirements." Must the Comptroller's Office revoke the exemptions it has granted to certain investment companies, and institute proceedings to collect franchise taxes for past years which have not been paid because the Comptroller's Office thought the companies involved to be exempt? It would certainly seem that the Comptroller has an obligation to follow the only available judicial construction of a statute, and to collect all of the tax revenue available to the State

under such a judicial construction, even if it means revoking previously-granted exemptions and filing lawsuits against companies which the State had previously exempted through an erroneous administrative construction. What if the Comptroller does not seek to revoke the five existing exemptions? Can a new open-end investment Company be denied an exemption for failure to meet the six "requirements" while at the same time the original five exemptions are allowed to remain in effect? Finally, has the statute now been rendered a nullity by the imposition of the six "requirements" by the courts? Seemingly so since no investment company can meet these "requirements".

In conclusion, Appellants submit that this case is a proper subject for this Court's plenary consideration on appeal. However, should this Court consider this appeal as improvidently taken, Appellants in that event request the Court to treat the foregoing as a Petition for Writ of Certiorari pursuant to the provisions of 28 United States Code, Section 2103.

Respectfully submitted

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APPENDIX A

Opinion of the Court Below

In the

COURT OF CIVIL APPEALS FOR THE THIRD SUPREME JUDICIAL DISTRICT OF TEXAS AT AUSTIN

No. 11,649

ROBERT S. CALVERT, COMPTROLLER OF PUBLIC ACCOUNTS ET AL,

Appellants

V.

CAPITAL SOUTHWEST CORPORATION ET AL,

Appellees

Opinion By Mr. Robert G. Hughes, A.J.

April 30, 1969

This appeal is from a judgment rendered after consolidation Causes 128,252, Capital Southwest Corpora-

tion v. Robert S. Calvert, Comptroller et al, Cause No. 127,416, Electro-Science Investors, Inc. et al v. the same defendants, and Cause No. 127,415, Texas Capital Corporation v. the same defendants.

Each of the plaintiffs below, appellees here, sued Robert S. Calvert, Comptroller of Public Accounts, Jesse James, Treasurer and Crawford C. Martin, Attorney General, all officials of Texas, to recover franchise taxes paid by them under protest, Capital Southwest seeking recovery of $251,448.94 plus interest, Electro-Science et al seeking recovery of $97,820.86 plus interest, and Texas Capital seeking recovery of $146,704.05 plus interest. Trial to the Court without a jury resulted in judgment for appellees in accordance with ther respective prayers.

There are no findings of facts or conclusions of law by the trial court and none was requested.

While appellants have five points and appellees five counterpoints, the parties agree that the sole issue presented is whether the three appellee corporations, severally, were "mutual investment companies" within the purview of Art. 12.03, Title 122-A, Taxation-General, V.A.C.S.,[1] during the respective periods of time in controversy and therefore exempt from the franchise tax imposed by Ch. 12, Title 122-A, Taxation-General.

[1] All statutory references herein are to Vernon's Annotated Civil Statutes unless otherwise noted.

Certain mutual investment companies were first granted exemption from the franchise tax by an amendment to Art. 7094 R.C.S. in 1951 when S.B. 6, Ch. 143, Acts 1951, 52nd Leg. p. 245 was enacted. There have been subsequent amendments to this statute, now Art. 12.03, supra, which are not relevant here and will not be noticed. We copy in full the 1951 amendment, including the emergency clause:

> "Be it enacted by the Legislature of the State of Texas:
>
> Section 1. That Article 7094, Revised Civil Statutes of Texas of 1925, as amended, be and the same is hereby amended so as to read hereafter as follows:
>
> 'Article 7094
>
> 'The franchise tax imposed by this Chapter shall not apply to any insurance company, surety, guaranty or fidelity company, or any transportation company, or to any corporation organized as a terminal corporation not organized for profit and having no income from the business done by it, or to any sleeping, palace car and dining car company now required to pay an anuual tax measured by their gross receipts, or to corporations having no capital stock and organized for the exclusive purpose of promoting the public interest of any city or town, or to corporations organized for the purpose of religious worship or for providing places of burial not for private profit, or to corporations organized for the purpose of holding

agricultural fairs and encouraging agricultural pursuits, or for strictly educational purposes, or for purely public charity, or to State-chartered building and loan associations, or to any mutual investment company registered under the Federal Investment Company Act of 1940, as from time to time amended, which holds stocks, bonds, or other securities of other companies solely for mutual investment purposes."

Sec. 2. The fact that the sole source of income of such mutual investment companies is from receipt of dividends or interest on stocks, bonds, or other securities of other corporations (held solely for investment purposes by such mutual investment companies), and the fact that such other corporations already are subject to and pay a franchise tax; that the subjection of such mutual investment companies to a franchise tax in effect taxes the same source twice, as is recognized by the Federal Government in exempting from Federal Income Taxes the income of such mutual investment companies which is distributed to their shareholders; the fact that mutual investment companies doing business in many other States are granted exemptions from franchise taxes whereas mutual investment companies doing business in the State of Texas are not exempt from franchise taxes, thereby placing the latter companies at an unfair disadvantage with respect to selling its shares to Texas investors; that such mutual investment companies should be encouraged to do business in Texas; that the calendars of both Houses are likely to become crowded; and

the further fact that the changes proposed herein need to become effective at the earliest possible time, create an emergency and an imperative public necessity, authorizing the Constitutional Rule requiring bills to be read on three several days in each House be suspended; and said Rule is hereby suspended, and this Act shall take effect and be in force from and after its passage, and it is so enacted."

This statute contemplates that in order for a corporation to be exempt from payment of franchise taxes that it: (1) be a mutual investment company; (2) be registered under the Federal Investment Company Act of 1940, as from time to time amended; (3) hold stocks, bonds, or other securities of other companies solely for mutual investment purposes; (4) receive its sole source of income from dividends or interest on stocks, bonds, or other securities of other corporations (held solely for investment purposes); (5) hold stocks, bonds, or other securities of only those corporations which are subject to and pay a franchise tax; (6) distribute its income to its shareholders in such a manner as recognized by the Federal Government in order to exempt its income from Federal Income Taxes.

Appellants discuss these statutory provisions as follows: (1) under Point One; (2) under Point Two; (3-6) under Point Four.

We observe that there is no material conflict or contradiction in the evidence.

Appellants' first Point is that the trial court erred in holding any of appellees to be a mutual investment company under Art. 12.03 because the charter and by-laws of each appellee preclude such classification.

Point Two is that the trial court erred in holding appellees mutual investment companies merely because they were registered under the Federal Investment Act of 1940.

We sustain these points.

Appellees were all small business investment companies registered under the Federal Investment Company Act of 1940 and licensed under the Small Business Investment Act of 1958.

The charters of each of these corporations and their amendments are in the record. A summary of these charters shows that each appellee had the authority[2] to operate as a Small Business Investment Company, to deal in stocks, bonds, debentures, obligations and evidences of indebtedness of foreign or domestic corporations, to consult and advise small business firms on a fee basis and to accumulate and lend money. In addition, Electro-Science had charter authority to invest in any manner not prohibited by law; to underwrite securities; to act as agent for underwriter; to engage in any mercantile, manufacturing or trading business;

[2] This listing of authority is not complete.

to enter into any kind of association; to engage in the oil business.

The management of each appellee is in its Board of Directors or Executive Committee, which Board or Committee appoints corporate officers whose duties and authority are stated in the by-laws.

An analysis of the by-laws, stock registration forms and prospectuses contained therein of appellees shows that all three will be governed by the Federal Small Business Administration and as a Small Business Investment Company; that the securities of each appellee are offered to the public as being "A Speculation,"[3] that the portfolio holdings of each appellee are "High Risk;" that all appellees contemplate control of and have exercised control of some of their portfolio companies; that each appellee proposes to furnish management, financial and advisory services for small business concerns, Texas Capital having executed contracts of advisement. All appellees may purchase or sell commodities or commodity contracts; all appellees may borrow money for the purpose of financing small business concerns; all appellees may be deemed under-

[3] "Speculation" is defined in Webster's Third New International Dictionary, unabridged (1966) as follows: "speculation 5a: an act of speculating (as by engaging in business out of the ordinary, by dealing with a view to making a profit from conjectural fluctuations in the price rather than from earnings or the ordinary profit of trade, or by entering into a business venture involving unusual risks for a chance of an unusually large gain or profit) . . . contrasted with investment."

writers of securities; all appellees may make long term loans; they may purchase warrants and options incident to stock of other companies; investment in appellees as Small Business Investment Companies are more significant to investors in the higher income tax brackets.

The term "mutual investment company" is found in only one Texas statute, Art. 12.03, supra.

The term was used in the Federal Reserve Act of 1937 and the Revenue Act of 1938.[4] Both of these Revenue Acts provided that a "mutual investment company" should meet certain requirements, one of which was:

> "Its shareholders are, upon reasonable notice, entitled to redemption of their stock for their proportionate interests in the corporation's properties, or the cash equivalent thereof less a discount not in excess of 3 per centum thereof."

These provisions were omitted from the revenue laws in 1942. The Act of 1942 granted certain favorable tax treatment to companies of a different type, having different qualifications and called a "regulated investment company."[5]

The conclusion is compelled that a regulated investment company is a very different type of company from

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[4] Title 26 U.S.C.A. "Internal Rev. Acts 1939 to date" (copyright 1940 (pps. 842-3) and id pps. 1124-1125, respectively.)

[5] See Title 26 U.S.C.A. Secs. 361, 381-385. (Internal Rev Code 1954).

a mutual investment company. Each time and only, in the Revenue Acts of 1937 and 1938, when the Congress defined a mutual investment company in accordance with the generally accepted qualifications of a mutual company did it refer to the company as a mutual. When it changed the nature of the company by defining it differently it changed the legal term used to refer to it from mutual to regulated.

In 1947, about three years prior to the enactment of the relevant amendment to Art. 12.03 in 1951, the case of New York Stocks, Inc. v. Commissioner of Internal Revenue, 164 Fed. 2d 75 (2d. Cir. 1947) was decided. The issue before the Court was whether earnings distributed on redemption of its shares were taxable under the Revenue Act of 1938. In holding for the taxpayer and in discussing the nature of a "mutual investment company" and the requirement that such companies redeem their stock as required by the Revenue Acts of 1937 and 1938 the Court said:

> "Petitioner, an 'open-end' investment company, offers shares of its stock for sale and invests the proceeds therefrom in securities. Its stock is issued in 21 series, each designated by the name of a different industry. As shares are sold the proceeds are invested in securities of those companies engaged in the industry indicated by the name of the series, and the shareholder participates only in assets derived from the series in which he holds a share of special stock.

[1] Petitioner's charter provides that any holder of special stock may, at his option, offer it to the petitioner for redemption on any day on which the New York Stock Exchange is opened for business. Special stock is redeemed at a figure equal to the shareholder's proportionate interest in the 'net asset value' of the series, less a small redemption charge. Included within the 'net asset value' of any series is the income accrued thereon during the taxable year. The net asset value is determined as of the date of redemption elected by the shareholder, and petitioner is obligated to pay the net amount payable on such redemption within three days after the determination thereof.

The background of the problem is found in the change in corporate taxation inaugurated in the 1936 Act. At this time, in order to avoid income accumulation by corporations, Congress enacted a drastic surtax upon undistributed income, Sec. 14, 26 U.S.C.A. Int. Rev. Acts, page 823, but allowed the corporation credit for dividends paid to its shareholders, Sec. 27, 26 U.S.C.A. Int. Rev. Acts, page 837. In the then subd. (g), which became (h) of the 1938 Act, it excluded from such credit dividends which were not fairly distributed among all of a class of shareholders, but gave some a preference in the distribution. Later acts made some changes in this general plan of corporate taxation, so that the applicability of Sec. 27, I.R.C., 26 U.S.C.A. Int. Rev. Code, Sec. 27, is now restricted to certain types of corporation, one of which was the 'mutual investment company' (the 'regulated investment company' of the 1942 and later Acts).

Since such a company was more a conduit for investment by small investors than an ordinary business corporation operated for profit, it was given special treatment, including not only the basic surtax credit of Sec. 27(b) for dividends distributed, but also the favor of a flat tax on its taxable income. Act 1938, Secs. 361, 362, 26 U.S.C.A. Int. Rev. Code, Secs. 361, 362 [p. 77] . . . We think the nature of such a company, defined and given favorable tax treatment under Sec. 361, has not been given due weight below or by the respondent. It offers a means by which the shareholder can presumably obtain expert supervision and diversity in his investment and at the same time retain complete discretion as to when to sell. At the sale of his shares the price is not determined by any capricious value judgment on the part of the petitioner, but rather by the vicissitudes of the market. The shareholder on selling stock of a special series gets his proportionate share of the accrued net income of those companies that make up the series. Thus one who redeems prior to a dividend date will get his pro rata share of the earnings for the period he held his shares, while he who retains his stock gets the earnings over the entire period. . . . But the statute requires this feature of the business in order that it qualify as a mutual investment company. . . . More important is the fact that every shareholder receives his fair proportion of the earnings during the period he elects to remain an owner, those redeeming being paid when they redeem, those retaining ownership being paid at the end of petitioner's dividend period. Since the

decision to retain or redeem is left to the unfettered judgment of the shareholder, there is no preference and no injustice to any shareholder." . . . [p. 78-79] (Italics added)

The term "mutual investment company" is defined in Webster's Third New International Dictionary, unabridged (1966) as follows:

"mutual investment company or mutual investment trust: an investment company that has a variable number of shares outstanding and that is ready at any time to issue or redeem shares at or near current liquidating value."

Mr. Lamar Ozley, Vice President of Texas Capital, testified on this subject as follows:

"Q Well, in characterizing yourself as a mutual investment company, how do you distinguish yourself from an investment company.

A I would say that the prime — I'm not real sure you can distinguish between an investment company under the Investment Company Act of 1940 and a mutual investment company. But the reason I consider us a mutual investment company is because of what I consider the mutuality of interest that our shareholders have in the portfolio companies we invest in.

Q Isn't that true of every investment company?

A I would say that might possibly be. I'm not really that clear on what other kind of company would be an investment company and not be a

mutual investment company. If you can describe one to me, then I would be willing to make a stab at it."

Mr. Clifford J. Osborn who testified on behalf of all appellees testified on this subject as follows:

"Q I believe you said a few minutes ago that a mutual investment company included holding companies, investment companies, mutual funds, closed-end investment companies. What distinguishes —

A I don't believe I included holding companies as a mutual investment company.

Q Why isn't a holding company a mutual investment company?

A Well, in my own personal definition, it's one that owns and controls and directs the companies it owns. A mutual investment company is a company whose intent in direction is the investment of its funds.

Q What makes an investment company a mutual investment company?

A They are all mutual investment companies. These companies right here are investment companies."

It is to be noted here that none of appellees is obligated to redeem its stock. Also, that few of the securities owned by appellees are listed on any stock exchange.

Our Texas insurance laws make a distinction between mutual insurance companies whose policyholders comprise its members and stock insurance shareholders may or may not be policyholders.[6]

Such stock insurance companies are never referred to as mutual companies. To make the distinction more clear, several statutes authorize mutual companies to convert to stock companies, and vice versa, for stock companies to convert to the mutual form.[7]

This process of converting from a stock to a mutual insurance company transfers ownership of the company from stockholders to the policyholders. This established procedure and condition has been described as follows:

> ". . . Mutualization involves the transfer of ownership of an insurance company from the stockholders to the policyholders. This change of ownership is brought about by the stockholders surrendering to the insurance company their stock for an agreed price. On the surrender of the stock, the company then belongs to the policyholders." Western and Southern Life Insurance Company v. United States, 163 F.Supp. 827 (U.S. Ct. of Claims, 1958) (at p. 829).

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[6] Vernon's Texas Insurance Code: Art. 1.14, Sec. 2; Ch. 11, particularly Art. 11.01, 11.04, 11.12 and 11.15; and Art. 21.27, 10.40 and 17.01; and Ch. 15 and 16.

[7] Vernon's Texas Insurance Code, Art. 11.01, Sec. 2 (c), 11.10, 21.27, 10.40 and 14.63.

Another distinguishing feature of a mutual company is that it usually has no capital stock. In a capital stock company the capital represents the interest of the stockholders and is composed of both capital and surplus. On the other hand, in a mutual company there is usually no capital, and surplus merely represents the excess by which assets exceed liabilities. For example, as to life insurance companies see the following Articles of the Texas Insurance Code: Articles 3.22; 11.01, Sec. 1, subd. 5 and Sec. 2 (C). As to mutual companies other than life see Article 15.04, subdivision 2, and Article 15.06. As to farm mutual companies see Article 16.06 (b). Further, as to this type of company only certain bona fide policyholders may be directors of the company. Art. 16.16.

Our Texas Legislature has authorized Mutual Loan Corporations by Title 46, Credit Organizations, subdivision 3, being Articles 2500 et seq. This Title also authorizes certain other types of co-operative credit and loan organizations. The type of loan organization denominated a Mutual Loan Corporation is a true mutual composed of member stockholders. The Legislature, by including this type of organization along with the other co-operative types covered by Title 46, has clearly expressed its intent that the term mutual is to be restricted to the pure mutual type of organization.

In addition, we find three different kinds of purely co-operative organizations which have been specifically

exempt from the franchise tax. These are: (1) Co-operative Credit Associations, Articles 2508-2513, exempt by Article 2512; (2) Farmers' Co-operative Societies, Articles 2514-2524, exempt by Article 2518; and (3) Corporations organized under Article 5737, et seq., the Co-operative Marketing Act, so named in Article 5738 (a) (3), exempt by Article 5764.

We also find that purely co-operative or mutual fire insurance companies are exempt from the gross premium receipts tax imposed by Article 7064 by the latter provisions of that Article.[8]

It is well settled that a franchise tax is levied by the State against certain corporations for the privilege granted them to do business in the State, and that whether they actually do any business is immaterial. Federal Crude Oil Co. v. State, 169 S.W. 2d 283, Tex. Civ. App. Austin, writ ref., cert. den. 320 U.S. 758 (1943).

It is elemental that a corporation has only such powers as are granted in its charter and that these powers can be amended only in the manner prescribed by law.

It is also well settled law that the charter of a corporation creates contractual relations between the

[8] The terms "cooperative" and "mutual" are often used interchangeably. Keystone Automobile Club Casualty Co. v. Commissioner of Internal Revenue, 122 F.2d 886 (3rd Cir. 1941, cert. den. 315 U.S. 814).

corporation and its shareholders, between the shareholders themselves, and that the rights growing out of this relationship are constitutionally protected. Hopkins Federal Savings & Loan Ass'n. v. Cleary, 296 U.S. 315, 340-341 (1935); St. Regis Candles, Inc. v. Hovas, 8 S.W. 2d 574, 579 (Tex. Civ. App., writ dism. 1928); Garey v. St. Joe Mining Co., 91 Pac. 369 (Utah Sup. 1907); Sommerville v. St. Louis Min. & Mill Co., 127 Pac. 464, 465 (Mont. Sup. 1912); Ferguson v. Meredith, 1 Wall, 25, 39-40 (1864); Mohall Farmers' Elevator Co. v. Hall, 176 N.W. 131 (N. Dak. Sup. 1920) and 13 Am. Jur. 2d, Corporations Secs. 25, 100, 225, 463.

When the public is concerned, the State has the right and the duty to confine a corporation to the powers granted in its charter. Taylor Feed Pen Co. v. Taylor Nat. Bk., 181 S.W. 534, Tex. Civ. App. Austin; rev. on other grounds 215 S.W. 850 (1919); Hopkins Federal Savings and Loan Association v. Cleary, 296 U.S. 315 (1935).

We are concerned here with the power and authority of appellees only insofar as they affect the rights of the State as reflected by this record.

Secs. A, B and C of Art. 2.22, Business Corporation Act, Vol. 3A, provide that the charter or by-laws of a corporation may restrict the sale or transfer of its stock as therein stated, Sec. C providing that "The pre-emptive rights of a shareholder to acquire unissued

or treasury shares of a corporation may be limited or denied by the articles of incorporation. . . ."

The charters of appellee Corporations expressly denied their shareholders any pre-emptive rights. They were all incorporated under the Texas Business Corporation Act.

The refusal of pre-emptive rights in effect creates three classes of shareholders: first, those owning a majority of the original issue of stock; second, those owning a minority of such shares; and third, those shareholders or outsiders favored who are allowed to purchase additional shares as opposed to shareholders who might have and exercise their pre-emptive rights to purchase such additional shares.[9] As a practical matter, a shareholders' interest in the corporation is diluted equally whether originally or newly authorized shares are issued and irrespective of the purposes or considerations for such issuances.

The voting strength of shareholders who are denied preemptive rights is curtailed to the extent they are denied the right to acquire additional shares.

The dilution of interest in the corporate assets and surplus and earnings of shareholders having no pre-

[9] For example, see Defs. Ex. 1, Ex. I thereof, p. 173 which shows that Texas Capital Corporation in offering its last issue of one million shares offered 977,000 shares to the public at $7.75 per share but offered 23,000 shares to designated or favored persons at the lesser price of $7.3625 per share.

emptive rights upon the issuance of additional shares is self evident.

Another aspect of the non-relatedness of the value of the shares of shareholders in the appellee companies with reference to their asset or liquidating or market value are the provisions of Articles 2.15 A, B and C of the Texas Business Corporation Act. These provide that shares, including treasury shares, may be issued by the corporation for such consideration as shall or may be fixed from time to time by the board of directors. Thus the value of shares has passed from the asset value of those shares and the value of those shares in the market to the board of directors. To compound the indefiniteness of the value of one's shares our courts hold that securities may be used in the payment of stock and that the value of these securities may be ascertained by other than their asset or market value. Commonwealth Bonding & Casualty Ins. Co. v. Hollifield, 220 S.W. 322 (Tex. Comm. App. 1920).

Texas Capital was incorporated with two classes of stock, the larger number of which was without voting rights. This provision together with the provisions in appellees' charters reserving to each the authority to dispose of treasury stock could adversely affect the value of shareholder's stock in many conceivable situations, some of which will be noted.

Shares of the minority, as to price per share, may sell for much less than the price per share of the majority

or of the component members of the majority, or of an individual or group who may own much less than the majority of the outstanding stock but who may still exercise an influential or dominant control over the directors and officers of the corporation. Or, the shares of the minority may have a market value measured by only a small percentage of the value of the majority shares; or such minority shares might have hardly any value at all. Perlman v. Feldmann, 210 F. 2d 173 (2d Cir. 1955, cert. den. 349 U.S. 952); Stanton v. Schenck, 251 N.Y.S. 221 (App. Div. 1931); Dawson v. National Life Ins. Co. of United States, 157 N.W. 929 (Iowa Sup. 1916); McCord v. Martin, 191 Pac. 89 (Calif. Dist. Ct. of App. 1920); Keely v. Black, 111 Atl. 22 (N.J. Ct. of Errors and Appeals = court of last resort = 1920); Dunnett v. Arn, 71 F. 2d 912 (10th Cir., 1934), on subsequent appeal, Roby v. Dunnett, 88 F. 2d 68 (10th Cir. 1937, cert. den. 301 U.S. 706); Tryon v. Smith, 229 P. 2d 251 (Ore. Sup. 1951).

To be a mutual company, it seems to us, all shareholders must have the right of equal opportunity to participate ratably in a sale of stock pursuant to an offer to purchase controlling shares at a favorable price. Otherwise stated, when a controlling shareholder sells his shares every other shareholder is entitled to have an equal opportunity to sell his shares, or a pro rata part of them, on substantially the same terms. Stated more broadly, any offer to buy, whether from a controlling or majority shareholder or otherwise,

must be made equally or proportionately to all shareholders. This is simply a guarantee of equality among shareholders in the relation to the market for the corporation's shares.

Still another mode of continuing control over each of the three appellee corporations in addition to a sale of the majority shares exists under the by-laws of each of appellees whereby that share control may be continued as an actual effective operating control. The by-laws of each of the three appellees provide that vacancies in the board of directors between meetings of the shareholders may be filled by the majority of the remaining directors.

Dividends are payable by each of appellees only at the discretion of its Board of Directors.

Each of appellees was chartered under the Texas Business Corporation Act as a Small Business Investment Company to operate under the Federal law and the rules and regulations of the Small Business Administration. We find nothing in these charters or in any of these statutes or authorities which impart any aspect of mutuality to any of appellees relative to their obligation to pay dividends to their shareholders.

None of the appellee companies have paid out earnings that they have accrued, on a quarterly or annual or any other regular basis, to the shareholders of the corporations either as dividends or in any other form. The shares of appellees are not cumulative. This means

that the shareholders' claims for dividends or distribution of earnings for all the past years and for all the periods of time in controversy in this suit, have expired and cannot be asserted at a later date. This is the general law. Wabash Railway Company v. Barclay, 280 U.S. 197 (1930).

It is true that a shareholder of a domestic corporation dissenting from certain corporate actions may demand payment of the fair value of his shares. See Secs. 5.11, 5.12 and 5.13, Business Corporation Act, Vol. 3A, V.A.C.S. These provisions, while helpful, do not equate minority and majority shareholders. They prohibit minority holders from sharing in any premium received by the majority shareholders by taking the action from which a dissent is made. Further, sales of shares by the majority is not a matter for dissent under the statutes. See Application of Marcus, 79 N.Y.S.2d 76, aff. 103 N.E.2d 338.

We believe that the requisite element of mutuality is lacking in the organization of each appellee for the reason that under their charters and by-laws the following actions, inconsistent with any idea of mutuality, may occur:

(1) Each shareholder may sell his own shares for what he can get for them and any premium he may receive for majority or controlling shares he keeps for himself;

(2) Any influence or control exerted by a group which owns a majority or controlling interest may affect adversely the share value of the minority shares and may enhance the share value of the majority shares at the expense of the minority;

(3) A dissenting minority group of shareholders may have to go into court and have the court determine the value of their shares instead of just dividing the total worth of the company between the total number of shares outstanding, as in an open end corporation;

(4) By reason of the exclusion of pre-emptive rights a favorite shareholder or shareholders, or even outsiders, may receive additional shares in the company to the exclusion of the existing shareholders and thereby dilute the asset or surplus value of those not receiving additional shares and in addition impairing or completely disfranchising the voting strength of those shareholders not receiving additional shares;

(5) Within the sole discretion of the directors strangers to the company may acquire shares by pre-emption and adversely affect both the per share value and per share voting strength of the existing shareholders;

(6) Directors of the company may withhold payment of earnings as dividends and thus force

a compulsory re-investment of capital of the shareholders;

(7) Directors of the company may withhold payment of earnings as dividends and thus force a distribution of earnings as either dividends or in other form to persons who were not shareholders at the time such earnings accrued;

(8) By reason of large blocks or controlling blocks of shares ownership interest may be emphasized on the basis of the value of particular blocks or shares rather than upon the value of the total shares or value of the company as distinguished from the proportionate value of the particular shares relative to the overall value of either the total number of shares outstanding or the total asset value of the corporation.

Texas Capital was notified by the Comptroller on June 22, 1961, that it occupied an exempt status under Art. 12.03. On July 10, 1961, the Comptroller, having had his ruling challenged by the office of the Secretary of State, addressed an inquiry to the Securities and Exchange Commission in Washington D.C. and received a reply dated July 20, 1961, from which we quote:

"Texas Capital Corporation is an investment company registered under the Investment Com-

pany Act of 1940, and its business is holding stock, bonds or other securities of other companies.

The term 'mutual investment company' is nowhere defined or even used in the Investment Company Act. The term 'investment company' is defined and Texas Capital Corporation is an investment company under that definition.

The investment company industry commonly uses the term 'mutual fund' to describe an investment company which constantly redeems its shares at current net asset value. Such a company is defined by the Investment Company Act as an 'open-end investment company.' (See Section 5(a) of the Investment Company Act of 1940). Texas Capital Corporation is not an open-end investment company since it does not constantly redeem its shares, and is therefore classified as a 'closed-end' investment company. It must be emphasized however that the terms 'mutual' or 'mutual fund' are nowhere used in the Investment Company Act.

It may also be of interest that the Internal Revenue Act of 1936 used the term 'mutual investment trust' and defined said term in Section 48. That definition included only companies whose securities were redeemable (open-end investment companies). Since that time the Internal Revenue Code has been changed and the term 'registered investment company' is used. This term includes both open- and closed-end companies. (See Subchapter M, Internal Revenue Code of 1954)."

On July 31st 1961, a memorandum in the Comptroller's office was made, reading:

"I feel that the information supplied by the Securities and Exchange Commission on July 20, 1961, clearly indicates that the subject corporation is subject to franchise tax and is not covered by that provision of Article 12.03 that deals with Mutual Investment Companies. I would say that there are two qualifications that a corporation must meet under this exemption. First, it must be a mutual investment company. Secondly, it must be registered under the Federal Investment Company Acts of 1940. Since the generally accepted term of mutual investment company is an open-end investment company, I feel that we can successfully defend the position that the Legislature intended. Mutual investment company to have its generally accepted meaning."

In answering a similar inquiry by the Comptroller concerning Electro-Science, the S.E.C. responded and said, in part:[10]

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[10] In House Report No. 2337 of the 89th Congress, 2d Session, entitled "Public Policy Implications of Investment Company Growth," the chairman of the U.S. Securities and Exchange Commission, Hon. Manuel F. Cohen, makes the following statement in his letter of transmittal to the President of the Senate and the Speaker of the House of Representatives, at page VII:

"This report initially describes the dramatic growth of the investment company industry since 1940, with particular emphasis upon mutual funds; i.e., those investment companies which continuously offer new shares to the public and continuously stand ready to redeem their existing shares at net asset value."

At page 43, the following statement appears: "Opened investment companies are commonly referred to as 'mutual funds.' Indeed this term has become a synonym for open-end investment companies."

> "A closed-end investment company may also fall within the definition of a 'mutual investment company' since the ownership of a share of stock in such a company is an interest in the portfolio holdings of the company in proportion to his stock ownership of the company."

Appellees say that the Comptroller in reversing his ruling as to their exempt status misinterpreted one S.E.C. letter and ignored the other. Whatever merit there may be in this assertion by appellees, we are not bound by the mistake, if any, of the Comptroller or the opinion of the S.E.C. as to the case before us.

Appellees argue that had the Legislature intended to exclude "closed end investment" companies, such as appellees,[11] from the exemption declared in Art. 12.03 it would have done so by express language. If the Legislature expressly provided for every contingency which might arise under any state of facts in enacting legislation there would never be any occasion for statutory construction. Unfortunately, this is not done, nor is it possible.

Appellees also contend that the term "mutual investment company" in the context of the entire statute includes both open-end and closed-end investment companies. Also, that to adopt appellants' construction of the statute would make the subject, a "mutual invest-

[11] Each appellee has acknowledged that it has neither redeemed nor offered to redeem any of its shares at any time.

ment company" more restrictive than the modifying phrases. We fail to follow the logic of this argument. If a statute provides that a white house with a chimney and a red picket fence is entitled to certain rights, would brown and green houses having chimneys and red picket fences also be included? It is our duty to give effect to all words used by the Legislature. We have attempted to discover what was intended by the use of the word "mutual" in Art 12.03.

Appellees call attention to the fact that the Federal Investment Company Act of 1940 (15 U.S.C.A., Secs. 80a-1, et seq.) does not use the term "mutual investment company." In fact, the term "mutual" is not to be found in it. Appellees say, "This fact clearly refutes the appellant's argument that the term mutual investment company should be given a special meaning." The logic of this argument escapes us. There is nothing in the Federal Investment Act of 1940 which bears on our problem. The provisions of the Act are so worded that it is convincingly clear that whether an investment company is mutual or some other type of investment company is immaterial.

We quote extensively from an article entitled "The regulation of the Investment Company Act of 1940 of Small Business Investment Companies Established under the Small Business Investment Act" in the Minnesota Law Review, Vol. 46, p. 143, 157-159 (1961)

which has been of great assistance to us and the statements in which have been utilized throughout this opinion:

> "The regulatory provisions of the 1940 act were directed particularly at the mutual fund type investment company which was prevalent in 1940. As a result, it has been contended that SBICs should be exempt from the 1940 act since they differ so completely from the mutual fund type investment company. In fact, Wendell B. Barnes, former administrator of the Small Business Administration, has asserted that the question of the applicability of the 1940 Act to SBICs would never have arisen had they not been called 'investment companies.'
>
> 'Upon examination it becomes clear that substantial differences do exist between the SBIC and the mutual fund company. For example, the mutual fund company was formed so that small investors might pool their funds and thereby gain the advantages of diversified investments and expert portfolio management. These companies traditionally invest in the conservative marketable securities of large corporations. Thus, such companies are able to satisfy the small investor who, because of his limited resources, desires safe investments with a uniform rate of return. On the other hand, SBICs are formed primarily to aid small businesses by furnishing these concerns with venture and expansion capital through the purchase of their securities. These securities are typically unlisted. In addition, they are not readily marketable be-

cause they represent investments in small business and often are extremely speculative and risky. Thus, the primary purposes and the investment policies of each of these companies are substantially different. A second major difference between these two types of investment companies is in the type of investor they attract. The mutual fund type company tends to attract the inexperienced investor who because of his lack of investment knowledge desires to place his funds in the hands of an expert manager. In contrast, the speculative nature of SBIC investments tends to attract the knowledgeable investor with large resources who seeks the speculative but potentially large profits and the tax advantages afforded the SBIC investor. In addition, the SBIC and mutual fund company differ in their methods of investing funds. The SBIC deals personally with the individual small business in negotiating financial arrangements whereas the mutual fund company makes its investments by purchasing securities of publicly held corporations on the open market. Although the differences between the two types of investment companies are substantial, it would be inaccurate to say that it is impossible for the 1940 act to regulate both types of companies effectively. However, these differences should arouse doubt as to whether the 1940 act can effectively protect investors and still promote the policies of the SBIC."

It is to be noted that each appellee was chartered for the purpose of operating as a Small Business Investment Company.

Appellees analyze the emergency clause of Art. 12.03 and their compliance with it as follows:

"EMERGENCY CLAUSE	FACTS ESTABLISHED
declares that the Legislature was concerned by:	in the case at bar established that:
(1) The fact that the sole source of income of such mutual investment companies is from receipts of dividends or interest on stocks, bonds, or other securities of other corporations held solely for investment purposes.	(1) Appellees, to the same extent as open-end investment companies, derive their income from the receipt of dividends or interest on stocks, bonds or other securities of other corporations held by Appellees solely for investment purposes.
(2) The fact that such other corporations already are subject to and pay franchise tax.	(2) The corporations in which the Appellees invest and from which they derive their income are subject to and pay franchise taxes to the State of Texas or some other state.
(3) That the subjection of such mutual investment companies to a franchise tax in effect taxes the same source twice.	(3) Subjecting the Appellees to the payment of franchise taxes (denying the exemption) is, in effect, taxing the same source twice.

(4) The fact that mutual investment companies doing business in many other States are granted exemptions from franchise taxes whereas mutual investment companies doing business in the State of Texas are not exempt from franchise taxes, thereby placing the latter companies at an unfair disadvantage with respect to selling its shares to Texas investors.	(4) Corporations similar to Appellees doing business in many other states are exempt from the payment of franchise taxes, placing Appellees at a disadvantage in selling their shares to Texas residents if the exemption is denied. States exempting open-end investment companies exempt closed-end investment companies, without exception, under the same statute.
(5) That such mutual investment companies should be entitled to do business in Texas.	(5) Appellants admit that to date only five (5) Texas companies have been afforded exempt status since 1951."

Upon the basis of this analysis, appellees contend that to serve the intent of the Legislative as expressed in the emergency clause they must be considered as "mutual investment companies."

This intent, appellees state, is: "The above-quoted clause unequivocally states that the object of the Legislature was to encourage these mutual investment companies to do business in Texas by removing the unfair disadvantages of double taxation, an object which is

equally applicable to both open-end and closed-end investment companies.

We also quote from appellees' argument (Brief p. 25-6) supporting the "Facts Established" which we have copied above:

> "There is an abundance of evidence to support each implied finding of fact in support of the trial court judgment. The Appellants agree that the evidence is generally undisputed (Appellants' Brief, p. 4). This evidence supports the trial judge's finding that the Appellee corporations met all of the characteristics of a mutual investment company suggested by Article 12.03 and the emergency clause accompanying the passage of the 1951 amendment into law, at least to the same extent as an open-end investment company. Included among these findings was that the double taxation rationale of the statute was as applicable to the Appellees as to open-end investment companies; that the Appellees were registered under the Federal Investment Company Act of 1940; that the Appellees held stocks, bonds, or other securities of other corporations solely for mutual investment purposes; that the income of Appellees is derived from dividends or interest from securities of other companies at least to the same extent as that of open-end investment companies; that those states exempting open-end investment companies also exempt closed-end investment companies without exception; and that therefore Appellees would be placed at an unfair disadvantage in

selling their shares to Texas investors should the exemption be denied the Appellees.

The foregoing facts are largely undisputed and are established by the great preponderance of evidence introduced at the trial. The evidence clearly establishes that the nature of the Appellee's business is the same as that of those open-end investment companies which have been granted the exemption, insofar as relevant.

The witnesses, Lamar Ozley and Clifford J. Osborn, both qualified as experts and gave the opinion that Appellees are all mutual investment companies. Therefore, the record adequately supports the trial court in the implied findings to that effect."

This is the extent of their argument and reference to the record to sustain the "Facts Established."

The record references given to sustain "Facts Established" (4) are excerpts from the laws of California, Minnesota, Colorado, Delaware, Oklahoma, Tennessee, Arkansas, New York and New Jersey. All of these statutory excerpts have been examined and they do not support the facts recited in (4). Since Appellees do not analyze or quote from these statutes, we refrain from burdening the record by copying or quoting from them. Suffice to say that none of the excepted statutes mentions "mutual investment companies." We quote from Appellants' Reply Brief in this respect:

"We have examined the laws of all other 49 states and we find no state which exempts or even mentions mutual investment companies in the context of their being exempt from or receiving favorable treatment under its franchise tax or other similar corporate tax laws. We do find several states which extend favorable tax treatment to regulated investment companies as defined under the Federal Income Tax laws. . . .

Our investigation of the laws of the other 49 states in this respect reveal that eight other states do extend favored treatment under their franchise tax, or other similar corporate taxing statutes to regulated investment companies, as defined under the present Federal Income Tax laws."[12]

With respect to "Facts Established" (2) and (3) the record shows that some of the portfolio companies of appellees have paid franchise taxes or license fees to the states of their incorporation.[13] In the States of Nevada, Colorado and New York, for example, an annual registration or license fee is charged. In Nevada this fee is $10.00. Appellees did not show that any of the securities of portfolio companies which they held were subject to these taxes or fees.

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[12] These states are Michigan, Minnesota, Missouri, North Carolina, Oregon, Pennsylvania and Rhode Island.

[13] These states are Arkansas, California, Colorado, Minnesota, New Jersey, New York, Nevada, Oklahoma and Tennessee.

Appellees' evidence of the payment of franchise taxes by their portfolio companies fails to show that any of the shares of stock of those companies, as distinguished from the privilege of the corporations themselves, were subject to any kind of tax or fee. No showing was made as to what properties of the portfolio companies were taxed nor the rate or amount of taxes paid by them.

If an investment company pays franchise taxes on its capitalization which is invested in securities forming the taxable capital of another corporation paying a franchise tax thereon, then, in a sense, the same source is taxed twice.

There is a distinction, however, which we believe is fundamental. This distinction separates shareholders from the corporation. The corporate property belongs to the corporation, not to the shareholders whose rights are equitable only. 14 Tex. Jur. 2d 126, Corporations, Sec. 11. Appellees are mere shareholders in their portfolio companies and they own no interest as such in the assets of the portfolio companies. In no event could there be double taxation here because Texas has not levied a tax on the same property twice. See authorities cited in Words and Phrases, Vol. 13, p. 568 et seq.

It is our opinion that appellees have not shown as sufficient basis for its "Facts Established" Nos. (2) and (3).

We believe that "Facts Established" (5) is not controlling. "Facts Established" (1) will be discussed later in this opinion.

Appellants' points three and four are the trial court erred in holding that appellees were mutual investment companies because the license of appellees as small business investment companies and their investments and because their modes of operation preclude such holding.

"The Small Business Investment Act of 1958 enacted by the 85th Congress, established an entirely new type of investment company licensed by the Small Business Administration (SBA) and regulated by that agency. In brief, the new act authorizes SBA to license privately-owned investment companies whose sole purpose is to invest money in companies qualifying as small business concerns under the definitions issued by that agency for the purpose of making equity capital investments and long-term loans." The Small Business Investment Act of 1958, by Andrew P. Murphy, Jr. and Charles H. Natter, Federal Bar Journal, Vol. 19, No. 2, April, 1959.[14]

At the time of the 1951 amendment of Article 12.03 the Small Business Investment Company was unknown. The bill which Congress enacted in 1958 was designed to meet a specific need with a specific remedy. A new type of company was to be chartered under

[14] The Small Business Investment Act of 1958 is Pub. L. 85-699, Aug. 21, 1958, 72 Stat. 689.

either State or Federal law and subject to regulation by the Small Business Administration. These companies would be supported by Federal funds and would provide debt and equity financing to small business concerns as well as advisory, management and consulting services.

Each of appellees was organized after enactment of the Small Business Investment Company Act of 1958 and each was chartered for the specific purposes authorized by that Act.

Illustrative of the manifest intentions of each of the appellees is a statement on the first page of the Registration Statement dated September 7, 1960 of Appellee Electro-Science Industries, Inc. filed with the U.S. Securities and Exchange Commission.

"The registrant has been organized expressly for the purpose of operating under the Small Business Investment Act of 1958, as amended, (the 'Act') and will operate in the manner and have the power and responsibilities and be subject to the limitations, provided by the Act and the regulations issued by the Small Business Administration (the 'SBA') . . ."

Likewise, Appellee Texas Capital Corporation has indicated the organizational basis for its existence in its Prospectus dated September 14, 1961 as filed with the U.S. Securities and Exchange Commission.

"Principal Aims and Objectives

Congressional studies have indicated that in

> order to obtain funds needed by small business concerns for the sound financing of their business operations and their growth, expansion and modernization, such concerns require long-term loan funds and equity capital which are frequently not available from banks or private venture capital. To make such funds available from private financing sources, Congress in 1958 enacted The Small Business Investment Act in order to provide a vehicle and set forth a program to stimulate and supplement the flow of private equity capital and long-term funds to such concerns through federally-licensed small business investment companies such as Texas Capital Corporation. . . ."

Similarly, Appellee Capital Southwest Corporation stated the exclusive purpose of its organization and operation in its Registration Statement filed with the Securities and Exchange Commission on July 12, 1961 as follows:

> "(c) The registrant has been organized expressly for the purposes of operating under the Small Business Investment Act of 1958, as amended (the 'Act'), and will operate in the manner and have the power and responsibilities and be subject to the limitations provided by the Act and the regulations issued by the Small Business Administration (The 'SBA'). . . ."

The Legislature could hardly have contemplated the exemption of a distinctive and specially-created type of company which was not even a possibility until

nearly six years after the exemption statute was enacted. The license of each of appellees limits its operations to those of a type which was unknown at the time of enactment of Article 12.03. The Texas Legislature could not delegate to Congress or the Small Business Administration the power to declare the nature or requisites of a mutual investment company.

The Small Business Investment Act of 1958 contains the following provision in Section 305(a). "Each company is authorized to make loans, in the manner and subject to the conditions described in this section, to incorporated and unincorporated small business concerns in order to provide such concerns with funds needed for sound financing, growth, modernization, and expansion."

The Prospectus of Appellee Texas Capital Corporation, dated September 14, 1961, and filed with the U.S. Securities and Exchange Commission, contains the following statements:

> "BUSINESS AND METHODS OF OPERATION
>
> The Company has ascertained in its operation so far that there are instances in which small business concerns are not corporations but, nevertheless, are worthy of receiving credit, and in two instances loans have been made thereto.
>
> The Company will also make long-term loans to small business concerns, both incorporated and unincorporated. . . ."

Counsel for Appellee Texas Capital Southwest Corporation pointed out to the trial court that it is perfectly legal for an SBIC to make an investment in an unincorporated business under Sec. 305 of the S.B.I. Act of 1958 and that Appellee Texas Capital had, in fact, done so.

If the income of appellees includes interest on loans to unincorporated businesses this income would not be from other incorporations as we construe Art. 12.03 to require. Also, since unincorporated businesses pay no franchise tax the purpose for which the exemption was included in Art. 12.03 would fail.

We do not believe that the securities held by appellees are characteristic of those commonly held by mutual investment companies. Certainly, they are not typical within the discussion in the Minnesota Law Review which we have quoted.

The Prospectus of Appellee Texas Capital Corporation dated September 14, 1961, and filed with the U.S. Securities and Exchange Commission, contains the following statements:

> ". . . It is not necessarily the company's policy to concentrate its investments in any particular industry, but it proposes to diversify its investments in small business concerns, which operate primarily in the State of Texas. Some of these concerns may be new and speculative companies, which in the judgment of management have

growth potential, but such growth cannot be assured. . . .

"There will be in most cases no market for the Company's portfolio securities, making it difficult to sell these securities until such time as the small business concerns in which the Company invests may develop to the point where a market is created for their securities. Until such market may develop it will be necessary for the Board of Directors to establish values for these portfolio securities."

The Prospectus of Appellee Electro-Science Investors, Inc. dated October 27, 1960, and filed with the U.S. Securities and Exchange Commission contains the following statements:

"Initially at least only a limited or no market will exist for the Company's portfolio securities. Consequently, such securities will not be readily salable until a market has developed and until such time as the Board of Directors may establish carrying values for the Company's portfolio securities based on such factors as book value, earnings, and its estimated prospects.

The companies in which the Company will invest will be small and subject to abnormal risks due to such factors as size, competition, responsiveness to general economic conditions, rapidly evolving technology and changes in military programs . . ."

The Vice-President of Appellee Texas Capital Corporation described the companies in which they invest

as "small" and "with a great deal of risk inherent in it." He described the portfolio of Texas Capital as "speculative to a degree."

The former President of Appellee Capital Southwest Corporation described the portfolio of securities of Capital Southwest as "high-risk."

The former President of Appellee Capital Southwest Corporation testified that the term "mutual funds" is the only instance in the securities market generally where the term "mutual" is used frequently. He further testified that SBIC's are "mutual investment companies," because the stockholders have a mutual interest in the investments which the company makes.

With respect to the rights of shareholders in Texas Capital Corporation, its Vice-President testified that its shareholders do not have any rights to acquire the underlying assets of the corporation; that they do not have the right to withdraw dividends or stock options received by the corporation; that they have no voting rights in the portfolio corporations; that they have, in fact, no rights other than those which any corporate shareholder would have in the assets of a usual kind of corporation, other than his rights to receive distributions of income before income tax.

These statements are also applicable to the other appellees.

Each of the appellees in denominated or controlled by a small group of large shareholders. For example, the following number of shareholders own more than five thousand shares of stock, representing the percentages indicated:

	(a) Total Shares	(b) No. of Shareholders Owning 5000 or more	(c) Percent of Total Owned by (b)
Texas Capital	1,535,300	33	26%
Capital Southwest	1,495,000	31	55.57%

As to Electro-Science Investors, Inc., four (4) of its stockholders who were also its officers and directors owned 34.8% of its shares.

All of appellees were organized by very large, high-bracket shareholders. Illustrative of the pattern is this excerpt from the Prospectus of Appellee, Capital Southwest Corporation:

> "Capital Southwest Corporation (the 'Company') was founded through the cooperative efforts of a group including the executive officers and directors of approximately 20 banks located in the Southwest. All of these banks invested in the stock of the Company and all but one have invested . . . the maximum amount permitted by law . . ."

Referring again to the Minnesota Law Review Article previously quoted it is manifest that appellees do not conform to the mutual type of corporations since they are controlled by large shareholders and since their shareholders do not have any right to acquire their proportionate share of the assets of the corporations.

Each of appellees has represented in statements filed with the Securities and Exchange Commission that its business would be to:

> "To supply financial, management and advisory services on a fee basis to the small business in which it has an investment; . . ." (Electro-Science)
>
> "To supply management, financial and advisory services on a fee basis to small businesses, primarily those in which the Company has invested." (Capital Southwest)
>
> "To provide management and financial counseling and other technical services on a fee basis for small business concerns which do not have such staff services available." (Texas Capital)

Each of appellees has rendered the type of services which they represented they would perform. The following tables reflect some, but not all, of the fees for services rendered by appellees:

	Electro-Science Investors, Inc.	Texas Capital	Capital Southwest
1960	$ —0—	$ —0—	$ —0—
1961	1,894.20	8,260.00	—0—
1962	3,910.50	15,760.00	—0—
1963	1,689.50	15,760.00	2,308.00
1964	1,472.30	17,812.00	475.00
1965	5,114.30	22,427.00	24,300.00
1966	7,575.00	27,966.00	24,050.00
1967	8,675.00	19,318.00	11,400.00

These fees do not constitute "interest or dividends on stocks, bonds or other securities of corporations" as stated in Art. 12.03.

We do not believe that the Legislative intended to exempt from the franchise tax some corporations engaged in the business activities above noted while taxing others similarly engaged.

Another source of income which has been realized by appellees is that of closing fees and commitment fees. These fees have been reported as additional interest. Appellee Texas Capital received, in a single transaction, a $1,000 appraisal and management fee and a $15,000 closing fee. A commitment fee aggregating $62,600 was realized from Public Radio Corporation by Appellee Texas Capital Corporation for a pledge at a bank. Appellee Texas Capital also received a management and initiation fee of $43,000 which was prepaid out of loan proceeds by Luke Parkway Development, Inc. Appellee Capital Southwest Corporation charges a commitment fee of 1% of the proceeds of any loans made.

These fees are related to but are not derived directly from the use of money. In our opinion these receipts are not interest and do not fall within the provisions of Art. 12.03.

There is another type of income which the record shows appellees to have received, i.e. stock options.

Appellee Texas Capital Corporations' accountant testified that there had been stock options acquired for no costs and that such options were not recorded on the books of the corporation at the time because of the uncertainty of their market value. He further testified that substantial values had been received which were unrecorded.

Appellee Texas Capital officers testified as to these specific options acquired: Big D Communications, Inc. (a portion of 905,166 shares); Rio Rojo Gathering System (2000 shares); Airborn, Incorporated (63,999 shares); Rio Sabine, Inc. (2000 shares); Gas Industries (510 shares); Petroleum Capital Company, Inc. (150 shares); Keystone Value Corporation (34,052 shares); Big D Outdoor, Inc. (2000 shares); Telesystems Corporation (25,000 shares); Southwestern Superior Products Corporation (135,000 shares); Ramo, Incorporated (300,000 shares). Also Texas Capital's accountant testified as to stock options from Arnold Pipe Rental Company, Inc.; Luke Parkway Development, Inc. (option for 50% of stock); American Home-builders (17,600 shares); U-Tote-M of Arkansas (150,000 shares) 27% of outstanding stock and Wolff & Marx (10,000 shares).

An Appellee Electro-Science official testified as to stock options received by the corporation in connection with loans made: Columbia Industries, Inc. (2500 shares) and General Electronics Control (175,000

shares). He stated that the corporation received stock options in about fifteen percent of the transactions in which it participated.

The method of operations of each of appellees is revealed in the pattern of acquisitions through stock options and commissions. It is significant to note that out of 59 loans made by Appellee Texas Capital that in 31 of them stock interests have been acquired. That out of 40 loans made by Appellee Electro-Science Investors that in 22 of them stock interests were acquired. And, that as to Appellee Capital Southwest Corporation that 40 of the 55 borrowers are partially owned by that appellee through stock interests acquired in the borrowing corporation.

It is clear that one of the principal business objectives of each of appellees is to realize income through the stock options and conversions which they have received. This is not, in any sense, income from interest and dividends. It is not the business of a mutual investment company. It is the business of that highly specialized and speculative type of loan company known as the SBIC.

Appellees have been in position to dominate or control many of the companies which they have financed. For example, Appellee Texas Capital Corporation owned 6 out of 31 corporations 100%; 4 corporations from 75-100%; 6 corporations from 50-74%; and 7 corpor-

ations from 30% to 49%. Appellee Capital Southwest Corporation owns 17 out of 40 corporations by more than 30%, including 1 by 100%; 1 by 98%; 2 by 88%; 2 by 80% and 1 by 50%. Appellee Electro-Science Investors owns very large shareholdings in many of its portfolio companies.

In addition to the very large stock ownership by appellees in most of their portfolio companies, appellees have elected Directors to serve on the Boards of most of them. In many instances, the combination of large stockholdings and Board representation has provided appellees with the power to operate and control the portfolio companies in the same manner as a holding company. The former President of Appellee Capital Southwest Corporation testified that the primary difference between a holding company and an investment company is the intent of the former to control the operations of the companies it owns. In the case of Appellee Texas Capital Corporation there is substantial evidence to indicate that it did in fact control and operate many of its portfolio companies.

The two basic essentials to a holding company control of its subsidiary corporations are characteristic of the appellees; namely, controlling or dominant stock ownership, and interlocking directorates.

The Texas statute contemplates only that a mutual investment company shall manage the monies of its

members by investing such monies in stocks, bonds or other securities of other companies solely for mutual investment purposes. The Texas Act clearly does not authorize such an exempt corporation to manage any aspect of the business or the business affairs or the internal affairs of any company in which it invests monies of its members. Nor does the Texas Act contemplate that such mutual investment company shall have business dealings with those companies in which it invests its monies other than such as are necessarily incident to the investment of such monies.

It seems to us that these facts tend to show that appellees more closely resemble holding companies rather than a mutual investment company which Art. 12.03 exempted from payment of franchise taxes.

The Investment Company Act of 1940 defines control as follows:

> " 'Control' means the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company.
>
> Any person who own beneficially, either directly or through one or more controlled companies, more than 25 per centum of the voting securities of a company shall be presumed to control such company . . . " 15 U.S.C.A., Sec. 80a-2 (9)

"Person" is defined in this Act of 1940 as a natural person or a company. 15 U.S.C.A., Sec. 80a-2.

We believe it clear from this record that appellees have the power to exercise controlling influence over the management and policies of companies whose securities it had purchased, and that these powers are not consistent with the type of company which the Legislature in Art. 12.03 selected for a tax exemption status.

Electro-Science did not file a formal election to be treated as a Regulated Investment Company under the Internal Revenue Act; however, a witness testified that from October 1960 to August 1967 it could have filed such election. Capital Southwest qualified for this status in 1968, and Texas Capital since 1960.

These facts are stated with reference to Art. 12.03, Sec. 2, wherein one of the reasons given for exempting mutual investment companies from the franchise was that the Federal Government exempts from income taxes their income which is distributed to shareholders.

If the purport of appellees' "Facts Established" (4) is that the sole source of their income is from the receipt of dividends or interest on stock, bonds, or other securities of other corporations held by them solely for investment purposes then it is not supported by the evidence, which as hereinabove set out is to the contrary. If this is not the purport of such "Established Fact," then it is irrelevant.

There is testimony in the record from Mr. Clifford Osborn who was an officer of Capital Southwest from

its inception until February 1968, that in his opinion appellees were mutual investment companies. We believe that the contrary is established as a matter of law from undisputed evidence and that the opinions expressed by Mr. Osborn constitute no more than a scintilla of evidence which is insufficient to raise an issue of fact. We reach this conclusion having in mind the following testimony of Mr. Osborn:

"Q Mr. Osborn, I believe you have testified that in your opinion Capital Southwest, Texas Capital and Electro-Science Investors are mutual investment companies, is that correct?

A Right.

Q Are all S.B.I.C.'s mutual investment companies?

A Basically, I would say yes they are because the stockholders have a mutual interest in the investments that the company makes, the investment companies.

Q So your understanding of the term of mutual investment companies' is that the stockholders have a mutual interest in the investments, is that correct?

A I think this is part of it, sure.

Q Is that true of every corporation?

A Are you asking, is it true that the stockholders have —

Q A mutual interest?

A Sure, they have a prorata interest depending upon the number of shares they own."

We also direct attention to the testimony of Mr. Osborn quoted earlier in this opinion.

It is obvious that Mr. Osborn does not give any significance to the word "mutual."

It is our opinion that the points made by appellants and sustained by us both severally and collectively require that this judgment be reversed and judgment here rendered that appellees take nothing by their suits.

Appellees have a counterpoint to the effect that if we hold as we have held then Art. 12.03 would be unconstitutional because it would unreasonably discriminate against them and would violate the due process and equal protection clauses of the Constitutions of the United States and Texas.

We overrule this point.

The discrimination which is said to exist is in not exempting "closed-end" investment companies as appellees are as well as "open-end" investment companies.

The Legislature has broad discretion in classifying subjects for tax purposes. Its only restriction is that the classification not be unreasonable or arbitrary. Considering the material differences between these two types of investment companies, as pointed out in this opinion, we do not believe the Legislature acted arbitrarily or unreasonably in exempting from payment

of franchise taxes only "open-end" or mutual investment companies.

The judgment of the trial court is reversed and judgment is here rendered that appellees take nothing by their suits.

Robert G. Hughes,
Associate Justice

Reversed and Rendered
April 30, 1969

APPENDIX B
Judgments and Orders of the Courts Below

No. 128,252

CAPITAL SOUTHWEST CORPORATION

v.

ROBERT S. CALVERT, COMPTROLLER
ET AL,

IN THE DISTRICT COURT
TRAVIS COUNTY, TEXAS
126TH JUDICIAL DISTRICT

No. 127,416

ELECTRO-SCIENCE INVESTORS, INC.

v.

ROBERT S. CALVERT, COMPTROLLER
ET AL,

IN THE DISTRICT COURT
TRAVIS COUNTY, TEXAS
126TH JUDICIAL DISTRICT

No. 127,415

TEXAS CAPITAL CORPORATION

v.

ROBERT S. CALVERT, COMPTROLLER
ET AL,

IN THE DISTRICT COURT
TRAVIS COUNTY, TEXAS
126TH JUDICIAL DISTRICT

ORDER OF CONSOLIDATION

On this the 10 day of July, 1968, came on to be heard the Motion for Consolidation filed in each of the above numbered and entitled causes, and came all parties in all three cases, plaintiffs, defendants, and intervenor, by their attorneys of record, and stated to the Court that the three cases involve a common question of law or fact and jointly moved the Court, by agreement of all parties, that the said common question of law or of fact in such three cases be consolidated, and the Court, having heard the joint motion of all parties for consolidation, is of the opinion that said Motion is well founded and proper and should be granted;

It is accordingly ORDERED AND DECREED that the common issue involving a claim of exemption from Texas franchise taxes in the three causes above numbered and styled be consolidated under the number and style of Cause No. 128,252, Capital Southwest Corporation, et al vs. Robert S. Calvert, et al; that said cases, having been tried at the same time, shall have a joint record; that if appeal is taken from the judgment of the Court, said common issue shall remain consolidated for purposes of appeal; that the Clerk shall prepare one transcript containing all matters required by law or requested by the parties in the said common issue in such three cases; that the Court Reporter shall prepare the Statement of Facts as a consolidated record; and that a copy of said Motion to Consolidate be filed

and a copy of this Order be entered in said new cause No. 128,252.

James N. Meyers
Judge

No. 128,252

CAPITAL SOUTHWEST CORPORATION, ET AL

vs.

ROBERT S. CALVERT, COMPTROLLER
ET AL,

IN THE DISTRICT COURT OF
TRAVIS COUNTY, TEXAS
126TH JUDICIAL DISTRICT

FINAL JUDGMENT

On the 27th day of May, 1968, came on to be heard Cause Numbers 128,252 (Capital Southwest Corporation vs. Robert Calvert, et al), 127,416 (Electro-Science Investors, Inc., et al vs. Robert S. Calvert, et al), and 127,415 (Texas Capital Corporation vs. Robert S. Calvert, et al), which said causes have a common issue which issue has since been consolidated into the above entitled and numbered cause wherein Capital Southwest Corporation, Electro-Science Investors, Inc., et al, and Texas Capital Corporation are Plaintiffs, and Robert S. Calvert, Comptroller of Public Accounts of the State of Texas, Crawford C. Martin, Attorney General of the State of Texas, and Jesse James, State Treasurer of the State of Texas, are Defendants, and the State of Texas is Intervenor; and, all parties having appeared by and through their respective attorneys of record and having answered ready for trial;

And, after the matters in controversy, of fact as well as of law, were submitted to the Court without the intervention of a jury, and the pleadings, the evidence, and the argument of counsel having been heard and fully understood, it is the opinion of the Court that the law and the facts are with each of the Plaintiffs and that Judgment against said Defendants and in favor of the Plaintiff Capital Southwest Corporation in the amount of $251,448.94; in favor of Plaintiff LTV Ling Altec, Inc. (successor to rights of Electro-Science Investors, Inc., Escon, Inc. and ESI Liquidating Corporation) in the amount of $97,820.86, and in favor of Plaintiff Texas Capital Corporation in the amount of $146,704.05, together with pro rata interest on each of said amounts, as provided for by law;

IT IS ACCORDINGLY ORDERED, ADJUDGED AND DECREED that Plaintiffs Capital Southwest Corporation, LTV Ling Altec, Inc., et al, and Texas Capital Corporation, be, and are hereby, exempt from payment of franchise taxes to the State of Texas as mutual investment companies under Article 12.03, Title 122-A, Taxation-General, Texas Civil Statutes and do have and recover of and from the Defendants, Robert S. Calvert, Comptroller of Public Accounts of the State of Texas, Crawford C. Martin, Attorney General of the State of Texas, and Jesse James, State Treasurer of the State of Texas, jointly and severally, the sums of $251,448.94, $97,820.86, and $146,704.05, respectively, together with the pro rata interest earned

on each of said sums until paid in full, all as provided by law, together with Plaintiffs' respective costs of suit. The State Treasurer and State Comptroller, Defendants herein, are hereby ordered to issue and deliver to the respective Plaintiffs warrants of the State of Texas to cover the refunds from the Suspense Account of the State Treasury in the amount of $97,820.86, plus statutory interest for Plaintiffs LTV Ling Altec, Inc., et al, $146,704.05, plus statutory interest for Plaintiff Texas Capital Corporation and $251,448.94, plus statutory interest for Plaintiff Capital Southwest Corporation.

IT IS FINALLY ORDERED, ADJUDGED AND DECREED that matters previously severed on behalf of Plaintiff Capital Southwest Corporation and Plaintiffs Electro-Science Investors, Inc., et al, shall be handled and disposed of in the manner set out in such formal Motions and Orders of Severance filed and entered in this Court prior hereto on this date.

It is further ORDERED that all relief not herein expressly granted is expressly denied. Whereupon, the Defendants and Intervenor herein duly objected and excepted and gave notice of appeal to the Court of Civil Appeals for the 3rd Supreme Judicial District of the State of Texas.

ENTERED this 10th day of July, 1968.

James N. Meyers
Judge

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No. 11,649

In the
COURT OF CIVIL APPEALS FOR THE THIRD SUPREME JUDICIAL DISTRICT OF TEXAS AT AUSTIN

ROBERT S. CALVERT, COMPTROLLER OF PUBLIC ACCOUNTS ET AL,

Appellants

V.

CAPITAL SOUTHWEST CORPORATION ET AL,

Appellees

Opinion By Mr. Robert G. Hughes, A.J.

April 30, 1969

THIS CAUSE came on to be heard on the transcript of the record and same being inspected, because it is the opinion of the Court that there was error in the trial court's judgment, IT IS THEREFORE considered, adjudged and ordered that the judgment of the trial court be and same is hereby reversed and judgment is here rendered that appellees take nothing by their suits. It is FURTHER ordered that appellees pay all cost in this behalf expended both in this Court and the court below and that this decision be certified below for observance.

NO. 13,809/11,649

In the
COURT OF CIVIL APPEALS FOR THE THIRD SUPREME JUDICIAL DISTRICT OF TEXAS AT AUSTIN

ROBERT S. CALVERT, COMPTROLLER OF PUBLIC ACCOUNTS ET AL

V.

CAPITAL SOUTHWEST CORPORATION ET AL

May 28, 1969

ORDER OVERRULING MOTION FOR REHEARING

Motion is submitted and overruled

No. B-1626

In the
SUPREME COURT OF TEXAS

CAPITAL SOUTHWEST CORPORATION
ET AL

V.

ROBERT S. CALVERT, COMPTROLLER
OF PUBLIC ACCOUNTS ET AL

From Travis County, Third District

October 1, 1969

ORDER OVERRULING APPLICATION FOR WRIT OF ERROR

Application of petitioners for writ of error to the Court of Civil Appeals for the Third Supreme Judicial District having been duly considered, and the Court having determined that the application presents no error requiring reversal of the judgment of the Court of Civil Appeals, it is ordered that said application be, and hereby is, refused.

It is further ordered that applicant, Capital Southwest Corporation et al., pay all costs incurred on this application.

No. B-1626

In the
SUPREME COURT OF TEXAS

CAPITAL SOUTHWEST CORPORATION
ET AL

V.

ROBERT S. CALVERT, COMPTROLLER
OF PUBLIC ACCOUNTS ET AL

From Travis County, Third District

November 5, 1969

ORDER OVERRULING MOTION FOR REHEARING OF APPLICATION FOR WRIT OF ERROR

Petitioners' motion for rehearing of application for writ of error having been duly considered, it is ordered that said motion be, and hereby is, overruled.

SUPREME COURT, U. S.

FEB 25 197

JOHN F. DAVIS, CI

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1969

NO. 1130

CAPITAL SOUTHWEST CORPORATION, ET. AL.,
Appellants

v.

ROBERT S. CALVERT, COMPTROLLER OF PUBLIC ACCOUNTS OF THE STATE OF TEXAS, ET AL.,
Appellees

ON APPEAL FROM THE COURT OF CIVIL APPEALS FOR THE THIRD SUPREME JUDICIAL DISTRICT OF TEXAS

MOTION TO DISMISS OR AFFIRM

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Jesse James, State Treasurer of Texas, and
Crawford C. Martin, Attorney General of Texas.

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1969

NO. 1130

CAPITAL SOUTHWEST CORPORATION, ET. AL.,
Appellants

v.

ROBERT S. CALVERT, COMPTROLLER OF PUBLIC ACCOUNTS OF THE STATE OF TEXAS, ET AL.,
Appellees

ON APPEAL FROM THE COURT OF CIVIL APPEALS FOR THE THIRD SUPREME JUDICIAL DISTRICT OF TEXAS

MOTION TO DISMISS OR AFFIRM

Appelleees, Robert S. Calvert, Comptroller of Public Accounts of Texas, Jesse James, State Treasurer of Texas, and Crawford C. Martin, Attorney General of Texas, move the Court to dismiss the appeal herein or, in the alternative, to affirm the judgment of the Court of Civil Appeals for the Third Supreme Judicial District of Texas, on the grounds 1) that the appeal does not present a substantial federal question, and 2) that the judgment of the Texas court rests on many adequate non-federal bases.

NATURE AND RESULT OF THE CASE IN THE TEXAS COURTS

The sole issue is the construction of the Texas statute; that issue is whether the three Appellant Corporations, severally, qualified as "mutual investment companies" within the purview of the Texas statute.[1] There was no material conflict or contradiction in the evidence. The decision of the Texas Court is the only decision of any court construing the statute.

Each of the three Appellants filed separate suits in the trial court. Since a common question was presented by these three separate suits, and since much of the evidence on the trial applied to each of the Appellants, the cases were tried jointly and concurrently. The three cases were consolidated into one final judgment in the trial court from which the three Appellants jointly appealed to the Texas Appellate Courts, and have presented their joint appeal to this Honorable Court.

THE TEXAS STATUTE

The Act of the Texas Legislature under consideration[2] reads as follows:

> *"Be it enacted by the Legislature of the State of Texas:*
>
> Section 1. That Article 7094, Revised Civil Statutes of Texas of 1925, as amended, be and the same is hereby amended so as to read hereafter as follows:

---

[1]Article 12.03, Title 122A, Taxation-General, (formerly Art. 7094), Vernon's Texas Civil Statutes, as amended by Acts of 1951, 52nd Leg., Regular Session, Ch. 143, p. 245. Subsequent amendments to this Act are not material to the case at bar.

[2]See footnote 1 at page 2 of this Motion.

"Article 7094

"The franchise tax imposed by this Chapter shall not apply to any insurance company, surety, guaranty or fidelity company, or any transportation company, or to any corporation organized as a terminal corporation not organized for profit and having no income from the business done by it, or to any sleeping, palace car and dining car company now required to pay an annual tax measured by their gross receipts, or to corporations having no capital stock and organized for the exclusive purpose of promoting the public interest of any city or town, or to corporations organized for the purpose of religious worship or for providing places of burial not for private profit, or to corporations organized for the purpose of holding agricultural fairs and encouraging agricultural pursuits, or for strictly educational purposes, or for purely public charity, or to State-chartered building and loan associations, or to any mutual investment company registered under the Federal Investment Company Act of 1940, as from time to time amended, which holds stocks, bonds, or other securities of other companies solely for mutual investment purposes."

"Sec. 2. The fact that the sole source of income of such mutual investment companies is from receipt of dividends or interest on stocks, bonds, or other securities of other corporations (held solely for investment purposes by such mutual investment companies), and the fact that such other corporations already are subject to and pay a franchise tax: that the subjection of such mutual investment companies to a franchise tax in effect taxes the same source twice, as is recognized by the Federal Government in exempting from Federal Income Taxes the income of such mutual investment companies which is distributed to their shareholders; the fact that mutual investment compa-

nies doing business in many other States are granted exemptions from franchise taxes whereas mutual investment companies doing business in the State of Texas are not exempt from franchise taxes, thereby placing the latter companies at an unfair disadvantage with respect to selling its shares to Texas investors; that such mutual investment companies should be encouraged to do business in Texas; that the calendars of both Houses are likely to become crowded; and the further fact that the changes proposed herein need to become effective at the earliest possible time, create an emergency and an imperative public necessity, authorizing the Constitutional Rule requiring bills to be read on three several days in each House be suspended; and said Rule is hereby suspended, and this Act shall take effect and be in force from and after its passage, and it is so enacted."

MODE OF PRESENTATION

This MOTION is presented under THREE POINTS which are as follows:

POINT I

This Honorable Court, and the Circuit Court of Appeals for the Second Circuit, and the Congress of the United States in two separate Acts, all have firmly established that for tax exemption purposes the distinction between mutual and non-mutual organizations is valid under the equal protection clause of the Fourteenth Amendment of the United State Constitution.

This POINT I is presented at pages 5-9 of this MOTION.

POINT II

The purpose of the Texas Statute was to exempt

from its franchise tax the type of corporation designated as, and having the well established characteristics of, a mutual investment company, and which corporation also should qualify under the additional five independent and mandatory requisites of the statute.

This POINT II is presented at pages 9-11 of this MOTION.

POINT III

Requisites Numbers three, four and five of the statute, as enumerated by the Texas Court, were not complied with by any of Appellants. Each is wholly unrelated to whether any Appellant was an open-end or a closed-end company.

This POINT III is presented at pages 11-13 of this MOTION.

POINT I

(Restated)

This Honorable Court, and the Circuit Court of Appeals for the Second Circuit, and the Congress of the United States in two separate Acts, all have firmly established that for tax exemption purposes the distinction between mutual and non-mutual organizations is valid under the equal protection clause of the Fourteenth Amendment of the United State Constitution.

Statement

These Court decisions and the Acts of Congress are established predicates and sufficient to uphold the constitutionality of the Texas statute against the claims of Appellants that the few elements of classification there-

in based upon whether a corporation is an open-end or a closed-end corporation are invalid.

Argument and Authorities

A State may adjust its revenue laws and taxing system in such a way as to favor certain industries or forms of industries; it may exempt from taxation kinds of business which it wishes to promote. *Liggett Co. v. Lee*, 288 U.S. 517, 570 (1933).

The basis for the holdings of this Court which have upheld classification of business organizations for tax exempt purposes because they were mutual or cooperative organizations, is cogently stated in the dissenting Opinion in *Liggett Co. v. Lee* (immediately supra) and is upheld in the opinions of this Court which it cites, as follows:

> "... But Americans seeking escape from corporate domination have open to them under the Constitution another form of social and economic control—one more in keeping with our traditions and aspirations. They may prefer the way of cooperation, which leads directly to the freedom and the equality of opportunity which the Fourteenth Amendment aims to secure. That way is clearly open. For the fundamental difference between capitalistic enterprise and the cooperative—between economic absolutism and industrial democracy—is one which has been commonly accepted by legislatures and the courts as justifying discrimination in both regulation and taxation. *Liberty Warehouse Co. v. Burley Tobacco Growers Assn.*, 276 U.S. 71. Compare *Citizens Telephone Co. v. Fuller*, 229 U.S. 322." (at page 579).

Other cases in which this Court has upheld the classifications of tax exempt organizations on the basis of their

being a mutual or beneficial type, against attacks under the equal protection clause of the Fourteenth Amendment, are: *Northwestern Mutual Life Insurance Co. v. Wisconsin,* 247 U.S. 132, 140, 141 (1918), and *Louisville Gas & Electric Co. v. Coleman,* 277 U.S. 32 (1928). This latter is the case so heavily relied upon by Appellants herein; on the other hand, we submit that it is squarely contrary to their position and is squarely in point in support of Appellees' position (at pages 33 and 40).

This Court has recognized the fundamental difference, valid for classification for being exempt from taxes pursuant to the equal protection clause of the Fourteenth Amendment, as stated in *First National Bank of Shreveport v. Louisiana Tax Commission,* 289 U.S. 60 (1933) wherein the Court said:

> ". . . There is a fundamental difference between banks, which make loans mainly from money of depositors, and the other financial institutions, which make loans mainly from the money supplied otherwise than by deposits. Compare *Northwestern Mutual Life Ins. Co. v. Wisconsin,* 247 U.S. 132, 140-141; *Louisville Gas & Electric Co. v. Coleman,* 277 U.S. 32, 40." (at page 64).

The *source* of money used in a business is a valid basis for classification. The Texas Court found that all of Appellants "may borrow money for the purposes of financing small business concerns; . . ." (441 S.W.2d 251; Jurisdictional Statement, p. 47). This power to borrow money carries with it a very substantial difference between an open-end and a closed-end investment company, as stated by Appellants in their APPELLEES' BRIEF in the Texas Court of Civil Appeals, at page 37, as follows:

". . . There is an undeniable distinction between the two types of investment companies. An open-end investment company in theory is continuously required to sell or redeem its shares at the net asset value of its portfolio securities. Conversely, closed-end companies, such as the Appellees, have a relatively fixed amount of capital, and their shares are bought and sold in the market at market price. Since closed-end investment companies may engage in the practice of borrowing money for investment purposes (trading on the equity), they possess an inherent leverage factor which is not present in open-end companies. For this reason, in a closed-end investment company, the value of its shares does not necessarily equal the net asset value of its portfolio securities."

Accord: *Puget Sound Power & Light Co. v. Seattle,* 291 U.S. 619, 625 (1934).

The Congress of the United States, in the Federal Revenue Act of 1937 and the Revenue Act of 1938, classified and granted exemption from the Federal Income Tax to a "mutual investment company." Such a company was required to constantly redeem shares of its stock or their proportionate interest in the corporation's property, or for the cash equivalent thereof less a small discount. These two Acts of the Congress are discussed in the Opinion of the Texas Court at 441 S.W.2d 252 (Jurisdictional Statement, pp. 47-48). Each of Appellants acknowledge that they have neither redeemed nor offered to redeem any of their shares at any time.[3]

These provision of the Revenue Act of 1938 were

[3]Statement of Facts in the Trial Court at the following pages and lines: p. 65:4-18; p. 193:20-p. 197:21; p. 259:24-p. 260:24; p. 583:4-17; p. 502:5-15.

construed in the case of *New York Stocks, Inc. v. Commissioner of Internal Revenue,* 164 F.2d 75 (2d. Cir. 1947). This case is cited, discussed and quoted from in the Opinion of the Texas Court at 441 S.W.2d 252-253 (Jurisdictional Statement, pp. 49-52). We especially invite the Court's attention to a careful reading of this portion of the Opinion of the Texas Court.

POINT II
(Restated)

The purpose of the Texas Statute was to exempt from its franchise tax the type of corporation designated as, and having the well established characteristics of, a mutual investment company, and which corporation also should qualify under the additional five independent and mandatory requisites of the statute.

Statement

Whether a corporation is an open-end or closed-end company is only one of the many and severally independent requisites which the Texas Court has held to be required by the statute in order to qualify as a mutual investment company.

Argument and Authorities

The Texas Court held that in order for a corporation to be exempt from payment of the tax that it must *be* a mutual investment company (441 S.W.2d 250, Jurisdictional Statement, p. 45).

The Court found that each of Appellants lacked the requisite element of mutuality in its organization for the eight reasons enumerated by the Court (441 S.W.2d 257-258, Jurisdictional Statement, pp. 62-64). The

Court's holdings are further documented and sustained by 1) the multiple decisions of this Court and the Circuit Court and the Acts of Congress, all of which are presented under POINT ONE of this MOTION, 2) the historical basis of the mutual concept as exemplified by other Texas statutes (441 S.W.2d 254-255, Jurisdictional Statement, pp. 54-56), and 3) the meaning of terms used in the securities field and in related Acts (441 S.W.2d 258-261, Jurisdictional Statement, pp. 64-70).

In addition, the Court made express holdings that each of Appellants, in the manner of the operation of its business, failed to qualify as a mutual investment company in the following respects:

1) Each was organized and licensed as a small business investment Company (441 S.W.2d 257, 263-265; Jurisdictional Statement, pp. 61,77-81);

2) The securities held are not characteristic of those commonly held by mutual investment companies (441 S.W.2d 265; Jurisdictional Statement, pp. 81-83);

3) The rights of shareholders in the assets of the Appellant companies are not in the investments they make and are not of the mutual kind (441 S.W.2d 265-266; Jurisdictional Statement, pp. 83-84);

4) The payment of earnings had not been on any kind of regular basis (441 S.W.2d 257; Jurisdictional Statement, pp. 61-62);

5) Each of Appellants is controlled by large shareholders (441 S.W.2d 266, Jurisdictional Statement, p. 84);

6) Each of Appellants has received substantial in-

come from the rendition of management, financial and advisory services or as closing and commitment fees (441 S.W.2d 266-267, Jurisdictional Statement, pp. 85-86);

7) One of the principle business objectives of each of Appellants is to realize income through stock options and conversions thereof (441 S.W.2d 267; Jurisdictional Statement, pp. 86-88);

8) Each of Appellants has exercised controlling influence over the management and policies of their portfolio companies (441 S.W.2d 268; Jurisdictional Statement, pp. 88-91).

By way of summary under this POINT TWO, none of Appellants has manifested any color of mutuality in either its organization or mode of operation.

POINT III
(Restated)

Requisites Numbers three, four and five of the statute, as enumerated by the Texas Court, were not complied with by any of Appellants. Each is wholly unrelated to whether any Appellant was an open-end or a closed-end company.

Statement

Each of the six requirements of the statute is independent from all others and equally mandatory. The judgment of the Texas Court may rest upon any one or more of them. Each of the requirements numbers three, four and five, severally, constitute an adequate non-federal basis to support the judgment.

Argument and Authorities

The judgment of the Texas Court may be independently supported by its holding relative to each, sever-

ally, of the requirements of the Texas statute designated as requirements numbers three, four and five (441 S.W.2d 250-251; Jurisdictional Statement, p. 45). Each of these is independent of the other, each is wholly unrelated to whether any Appellant was an open or closed-end company, and each such requirement is a non-severable and mandatory requirement of the Texas Statute. The judgment is fully supported upon each of these non-federal grounds.

Requirement No. Three is that an exempt corporation shall "hold stocks, bonds, or other securities of other companies solely for mutual investment purposes." Instead, the Court found that each of Appellants had exercised control over their portfolio companies and that one of the principle business objectives of each of Appellants was to realize income through stock options and their conversions (441 S.W.2d 267-268; Jurisdictional Statement, pp. 86-91).

Requirement No. Four of the Texas statute is that an exempt corporation must "receive its sole source of income from dividends or interest on stocks, bonds, or other securities of other corporations (held solely for investment purposes)." Contrary to this requirement, each of Appellants received fees for services in the nature of management, financial and advisory services (441 S.W.2d 266-267; Jurisdictional Statement, pp. 85-86); each of Appellants received fees denominated closing and commitment fees (441 S.W.2d 267; Jurisdictional Statement, p. 86); and each has received, as one of its principle business objectives, income through stock options, and their conversions (441 S.W.2d 267; Jurisdictional Statement, pp. 86-88).

Requirement No. Five of the Texas statute is that

an exempt corporation must "hold stocks, bonds, or other securities of only those corporations which are subject to and pay a franchise tax." Appellants' failure to comply with this requirement leaves wholly unsupported their claim that they have been subjected to double taxation. (441 S.W.2d 262-263; Jurisdictional Statement, pp. 74-76).

CONCLUSION

WHEREFORE, Appellees respectfully submit that the questions upon which this appeal is predicated are so unsubstantial as not to need further argument and that the judgment of the Texas Court rests on many adequate non-federal bases. Appellants respectfully move the Court to dismiss this appeal or, in the alternative, to affirm the judgment by the Court of Civil Appeals for the Third Supreme Judicial District of Texas.

Respectfully submitted;

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APPENDIX A

DENIALS OF STATEMENTS IN APPELLANTS' JURISDICTIONAL STATEMENT

The following statements of purported facts at the following pages of Appellants' Jurisdictional Statement are denied because they are wholly contrary to both the record and the opinion of the Court below:

1) At page 15:

> "It is undisputed that at all material times each of the Appellants was an investment company registered under the Federal Investment Company Act of 1940 *which held stocks, bonds and other securities of other companies solely for mutual investment purposes. . . .*" (emphasis added).

The underscored language is categorically denied; both the record and the opinion of the Texas Court refute this statement of fact.

2) At page 29:

> "It is a matter of common knowledge that the five open-end investment companies which have been granted an exemption derive their greatest amount of income from realized appreciation of their portfolios."

3) At page 31:

> "Both the Appellants and Appellees agree that in 1951 at the time of the enactment of the exemption in question, there was no common definition of the term 'mutual investment company.' (441 S.W.2d at 252) . . ."

The four authorities in complete refutation of this misstatement of fact, the Federal Revenue Act of 1937

and the Revenue Act of 1938, the case of *New York Stocks, Inc. v. Commissioner of Internal Revenue,* 164 F.2d 75 (2d Cir. 1947) and Websters Third New International Dictionary, are cited and discussed by the Court (441 S.W.2d 252-253; Jurisdictional Statement, pp. 48-52).

APPENDIX B

TYPOGRAPHICAL ERRORS IN JURISDICTIONAL STATEMENT OF APPELLANTS

The following tyopograhical errors appear in Appellants' Jurisdictional Statement, as follows:

1) At page 54, the word whose has been omitted from the beginning of the fourth line from the top of the page.

2) At page 57, the fifth line, the style of the case cited as *St. Regis Candles, Inc. v. Hovas* should be *St. Regis Candies, Inc. v. Hovas;*

3) At page 57, in the ninth line, the style of the case cited as *Ferguson v. Meredith,* should be *Clearwater v. Meredith.*

CERTIFICATE OF SERVICE

I, William Edward Allen, Assistant Attorney General of Texas, certify that a copy of the foregoing Motion to Dismiss or Affirm was served on the Attorneys for Appellants, by depositing same in the United States Mail, first class postage prepaid, certified mail, addressed to the following attorneys of record for Appellants:

1) Messrs. Henry D. Akin, Jr. and Charles J. McGuire, III
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all having been so mailed on the ____ day of February, 1970.

I do further certify that copies of the Jurisdictional Statement filed by Appellants in this No. 1130 were received by Attorneys for Appellees on January 30, 1970.

WILLIAM EDWARD ALLEN
Assistant Attorney General

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IN THE

Supreme Court of the United States

October Term, 1969

NO. 1130

CAPITAL SOUTHWEST CORPORATION, ET AL,
Appellants

v.

ROBERT S. CALVERT, COMPTROLLER OF PUBLIC ACCOUNTS OF THE STATE OF TEXAS, ET AL,
Appellees

ON APPEAL FROM THE COURT OF CIVIL APPEALS FOR THE THIRD SUPREME JUDICIAL DISTRICT OF TEXAS

APPELLANTS' REPLY TO MOTION TO DISMISS OR AFFIRM

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ON APPEAL FROM THE COURT OF CIVIL APPEALS FOR THE THIRD SUPREME JUDICIAL DISTRICT OF TEXAS

APPELLANTS' REPLY TO MOTION TO DISMISS OR AFFIRM

Appellants wish to make this brief reply to the Appellees' Motion to Dismiss or Affirm filed herein, and in so doing will treat each of the three Points presented by the Appellees.

Under Point 1

Appellees again have refused to correctly state the basic legal principles upon which the validity of a statute creating a discriminatory classification is tested under the equal protection and due process

clauses of the Fourteenth Amendment of the United States' Constitution. Appellants acknowledge that the Fourteenth Amendment does not prohibit all discrimination *per se*. It is only when the discrimination which results from classification is unreasonable or arbitrary that the guarantees of equal protection and due process are abridged.

Appellants in their Jurisdictional Statement (pp. 25-27) have set forth landmark decisions handed down by this Court wherein the test to be applied in ascertaining whether or not such a resulting discrimination is unreasonable or arbitrary has been enunciated. To paraphrase, the discriminatory classification must rest upon differences bearing a reasonable and just relation to the *purpose and object* of the legislation. The mere fact that differences exist between the favored entity and the entity discriminated against is irrelevant unless the purpose and object of the legislation has a reasonable relation to these differences. Only by paying heed to the foregoing can the overall aim of these constitutional guarantees to treat alike all persons similarly circumstanced be realized.

Appellees, in their Motion to Dismiss or Affirm, have in essence said the purpose of the statutory exemption can be ignored. Appellees maintain that since differences do exist between open-end and closed-end investment companies, the classification which now has resulted in discrimination against the Appellants must certainly be a proper exercise of the state's power to

tax. In their wild scramble to cite differences, Appellees repeatedly refuse to relate the differences to the purpose of the exemption statute which is clearly set forth in the emergency clause accompanying its enactment. Appellees further confirm their position by their erroneous treatment of the cases they cite under Point I. This Court in all the cases cited by Appellees therein expressly considers the purpose of the particular statute in issue, and relates the purpose to the differences associated with the party discriminated against. For example, even the dissenting opinion in *Liggett Co. v. Lee*, 288 U. S. 517 at 576, 53 S. Ct. 481, 77 L.Ed. 960 cited by Appellees contains the following statement:

> "Whenever the discrimination is for a permitted purpose — as when a State, having concluded that activity by corporations should be curbed, seeks to favor businesses conducted by individuals — the corporate character of the owner presents a difference in ownership which may be made the sole basis of classification in taxation, as in regulation. The discrimination cannot, in such a case, be held arbitrary, since it is made in order to effect the permitted hostile purpose and is appropriate to that end." (Emphasis added.)

Furthermore, in their Motion to Dismiss or Affirm, Appellees make the statement that the case of *Louisville Gas & Electric Co. v. Coleman*, 277 U.S. 32, 48 S. Ct. 423, 72 L.Ed. 770 at page 40 supports their position that legislative purpose can be ignored, and yet

the following is the statement found on the designated page:

> "It is made clear by the lower court that the purpose of the exemption was to enable these associations, by relieving them of a burden, more completely to carry out the quasi-public purpose which the legislature designed in providing for their creation." (Emphasis added.)

Concluding their reply to Appellees' Point I, Appellants submit that the differences which do exist between open-end investment companies and Appellants, as closed-end investment companies, cannot form a valid basis for the discriminatory classification because the differences bear no reasonable and just relation to the *purpose* of the exemption statute spelled out in its emergency clause and commented on in Appellants' Jurisdictional Statement (pp. 10-11, 26).

Under Point II

It is unclear to Appellants under this point what the Appellees strive to point out. However, lest there be any confusion as to what the Texas Court of Civil Appeals held, the Court is referred to the holding of the case (441 S.W. 2nd at 269, Jurisdictional Statement 93-94):

> "Considering the material differences between these two types of investment companies, as pointed out in this opinion, we do not believe the Legislature acted arbitrarily or unreasonably in exempting from payment of franchise taxes only 'open-end' or mutual investment companies."

Since the Texas court was asked to construe the statute in question, there can be no doubt that the foregoing is the holding of the case.

Under Point III

Appellees here seek to maintain that there are independent adequate non-federal grounds to support the judgment of the Texas Court of Civil Appeals. In so urging, Appellees have selected three so-called "requirements" which the Texas court found to be prerequisites to exemption under the statute in question.

In reply, it is Appellants' understanding that three elements must be present before it can be said that a case coming before the Court on appeal rests on independent adequate non-federal grounds: (1) the decision must in fact rest on a non-federal ground, (2) the ground must be independent of the federal question so as to qualify as a non-federal ground, and (3) the non-federal ground must be adequate in and of itself to support the decision. Lacking any one of these three elements, a case will not be deemed to rest on independent adequate non-federal grounds. Appellants say that none of these three elements is present in this case.

First, recalling that the holding of the case is that the exemption is only available for open-end investment companies, Appellants say this holding cannot possibly be based on the three "requirements" advanced by Appellees as non-federal grounds. In their Jurisdictional Statement (pp. 27-29) Appellants demonstrate

that if the "requirement" labelled number Four by Appellees is in fact a requirement, no investment company, including open-end ones, can qualify. Since it is impossible for any open-end investment company to meet this so-called "requirement," and since the holding of the Texas court was that only open-end investment companies were exempt, obviously the Texas court could not have based its holding on a ground with which open-end investment companies could not comply. As for the "requirements" Appellees have labelled Three and Five, Appellants deny what is therein said by Appellees. Under Three, if the Court will refer to the pages of the opinion cited the Court will see that the Texas court never found that each of the Appellants had exercised control over their portfolio companies. As for Five, Appellants have treated this in their Jurisdictional Statement (pp. 29-31).

Second, the non-federal grounds asserted by Appellees are not independent of the federal question presented. Appellants merely submit that to read the opinion of the Texas Court of Civil Appeals is to see how intertwined these alleged non-federal grounds are with the federal question. This is high-lighted by the following portion of the Texas court's holding quoted in full above (441 S.W. 2nd at 269, Jurisdictional Statement pg. 93):

> "Considering the material differences between these two types of investment companies, as pointed out in the opinion, ..."

Third, the alleged non-federal grounds are not adequate. It is well established that in order for a non-federal ground to meet the test of adequacy it must be tenable. Recalling Appellants' point above to the effect that the so-called "requirements" are impossible for even an open-end investment company to comply with, how can these alleged grounds be adequate when to incorporate them precludes even open-end investment companies from being exempt.

Concluding, under Point III, Appellants say that the Texas court's decision does not rest upon independent adequate non-federal grounds so as to preclude this Court's plenary consideration of this case on appeal.

Respectfully submitted,

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CERTIFICATE OF SERVICE

We, the Appellants herein, hereby certify that copies of the Appellants' Reply to Motion to Dismiss or Affirm herein have been served upon the attorneys of record for Appellees in the within cause by depositing same in the United States Mail, with proper first class postage prepaid, pursuant to Rule 33 of the Revised Rules of the Supreme Court of the United States, addressed to the Honorable Crawford C. Martin, Attorney General of Texas, Box "R", Capitol Station, Austin, Texas 78711; Mr. Nola White, First Assistant Attorney General, Box "R", Capitol Station, Austin, Texas 78711; Mr. Alfred Walker, Executive Assistant Attorney General, Box "R", Capitol Station, Austin, Texas 78711; Mr. John R. Grace, Assistant Attorney General, Box "R", Capitol Station, Austin, Texas 78711; Mr. W. E. Allen, Assistant Attorney General, Box "R", Capitol Station, Austin, Texas 78711; and Mr. William B. Hilgers, Special Assistant Attorney General, 300 West Eighth Street, Austin, Texas 78701, on this 27th day of February, 1970.

We further certify that all parties required to be served pursuant to the Revised Rules of the Supreme Court of the United States have been served.

HENRY D. AKIN, JR.
On behalf of all Appellants
herein with consent of Appellants'
individual counsel.

SUPREME COURT OF THE UNITED STATES

October Term, 1969

CAPITAL SOUTHWEST CORPORATION ET AL. *v.* CALVERT, COMPTROLLER, ET AL.

APPEAL FROM THE COURT OF CIVIL APPEALS OF TEXAS, THIRD SUPREME JUDICIAL DISTRICT

No. 1130. Decided March 23, 1970

PER CURIAM.

The motion to dismiss is granted and the appeal is dismissed for want of a substantial federal question.